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"PROPERTY" IN THE CAPITAL ASSET DEFINITION: INFLUENCE OF "FRUIT AND TREE"

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I. INTRODUCTION

THE famous metaphor of Justice Holmes concerning the "fruit and the tree"[1] has permeated the tax law to an extent that probably not even its author could have predicted. Attractive enough as a seedling, thirty-five years later it shows the result of insufficient pruning. The capital gains landscape is dominated by "fruit and tree," and its progeny, and it has encroached into places in the garden where it is neither desirable nor necessary. The purpose of this article is to offer the current status of the effect of this metaphor upon the meaning of "property" in the capital asset definition.

"Capital gain" is defined as "gain from the sale or exchange of a capital asset,"[2] and a "capital asset" is all "property"[3] not within five specific exclusions.[4] The meaning of the word "property" has probably been the subject of more recent litigation than any other single word in the Internal Revenue Code. A literal application of the definitional section would give capital gain treatment to receipts from a sale or exchange of anything of value not within the exclusions. The relative narrowness of the exclusions and the resulting broadness of the capital asset definition results in a vast area of property interests which is constantly being probed and tested by taxpayers in the hope of receiving the preferred tax treatment. The courts are besieged by suits for capital gains treatment where the property involved does not nicely fit into the exclusionary cate-

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1. Lucas v. Earl, 281 U.S. 111 (1930).
2. Int. Rev. Code of 1954, § 1222(3).
3. Int. Rev. Code of 1954, § 1221.
4. (1) Stock in trade, inventory and property held for sale to customers, (2) depreciable and real property used in the trade or business, (3) copyrights, literary, musical or artistic property in the hands of the creator and certain others, (4) certain receivables, (5) certain governmental obligations. Int. Rev. Code of 1954, §§ 1221(1), (2), (3), (4), (5).

gories set forth by Congress. Such assets as accrued salary, accrued interest and prepaid rent, laying claim to "property" status, have contended for capital gain treatment. Other cases have involved sales or cancellations of personal service contracts, insurance contracts, sales agency contracts, distributorships, favorable purchase contracts and negative covenants. Also involved have been interests in property which are part of a larger estate, such as "carved out" oil payments, life estates and leases.

Attempting to limit the range of preferred treatment, the courts essentially have ignored the statutory definition of capital assets, and have substituted a series of judicial concepts. In recent years there have evolved quite a number of these concepts, mainly derived from decisions of the United States Supreme Court. Often, the standards which have been developed do little more than state conclusions as to whether the receipt is capital gain or ordinary income, or proceed from premises which seem to bear little or no relation to capital gains policies.[5]

The standards are confusing, sometimes inconsistent, and even irrelevant. Thus, where a lessor of real property receives from his lessee a lump sum payment in cancellation of a lease, he is said to receive "a substitute for future rentals"[6] which is ordinary income. This is not the case if the lease is favorable to the lessee. Any payment to him in cancellation of the lease is capital gain. This is so even though he is sub-leasing the premises and, being in the position of landlord as well as tenant, also receives the value of "future rentals."[7] Also, the lessee is held to have engaged in a "sale or exchange"[8] while the lessor has not.[9] Or, if a lessor "sells" a term for years for a lump sum payment, he has ordinary income.[10] But if the term for years is cast in the form of a life estate, a sale will bring capital gain[11] even though the seller continues to hold the remainder.[12] In another setting, if an employee receives a lump sum payment in cancellation of a long term employment contract, he has ordinary income because he has nothing he can sell,[13] or because he has received only a "substitute for future ordinary income."[14] But, if the right to perform future services for compensation is embodied in an "exclusive agency" contract, then capital gain is possible because what has been sold is a "business," even though the substance

5. See generally, Note, *Capital Gains: Can the Confusion Be Eliminated?*, 49 Iowa L. Rev. 89 (1963); Note, *The Troubled Distinction Between Capital Gain and Ordinary Income*, 73 Yale L.J. 693 (1964).

6. Hort v. Commissioner, 313 U.S. 28 (1940).

7. Metropolitan Bldg. Co. v. Commissioner, 282 F.2d 592 (9th Cir. 1960).

8. Commissioner v. Ray, 210 F.2d 390 (5th Cir. 1954), *cert. denied*, 348 U.S. 829 (1954).

9. Spray Water Power & Land Co., 20 T.C.M. 353 (1961).

10. Burnet v. Harmel, 287 U.S. 103 (1932).

11. Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943).

12. Estate of Johnson N. Camden, 47 B.T.A. 926 (1942), *aff'd per curiam*, 139 F.2d 697 (6th Cir. 1943).

13. Thurlow E. McFall, 34 B.T.A. 108 (1936).

14. Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962).

of what has been transferred is the right to perform personal services.[15] Again in the area of contracts, a right to sell for commission the entire output of a coal mine is not a capital asset because it is a "naked contract right."[16] On the other hand, it is clear that gain on the sale of an appreciated bond or debenture is capital gain, and it is difficult to think of a contract more "naked."[17]

These examples are not intended so much to be critical of the courts as to demonstrate some of the results of their struggle to define the word "property." Their task is not an enviable one. The statute is not adequate to deal with the problem. Nor has the tax law had the benefit of a "capital gain" concept from other disciplines. The economist tends to define "gain" as accretions to wealth, but has no concern with the notion of "capital gain" as distinguished from "income."[18] Nor does the accountant have a notion of "capital gain" which is helpful under the tax law. He is concerned with notions of recurring and nonrecurring receipts and has a concept of capital gain which is narrower than one necessary to solve tax problems.[19] The rules governing capital gains taxation are, therefore, essentially judicially developed in the traditional common law way. It is the thesis of this paper that the development has been mistakenly influenced by the decisions of the United States Supreme Court in an area which has only a superficial bearing on the capital asset definition—the "assignment of income cases."[20] In these cases, the Court was dealing not with the nature of gain but with the choice of taxable person. It was clear that the receipt was to be taxed as ordinary income and the only question was whether the assignor or the assignee should pay the tax. However, the Court placed primary reliance on these cases in struggling with the meaning of "property" in the capital asset definition. The inquiry becomes whether these cases are sufficiently related to the capital asset problem to be allowed such influence. This paper will briefly review the most pertinent of these decisions and discuss their influence in the formulation of the capital asset definition by the courts. To place the problem into perspective, however, brief inquiry is necessary into the intent of Congress in giving preferred tax treatment to "capital assets."

II. The Intent of Congress

In 1921 Congress first defined the term as only that property "acquired" for "profit or investment." Specifically excluded from the definition were in-

15. Elliot B. Smoak, 43 B.T.A. 907 (1941); Jones v. Corbyn, 186 F.2d 450 (10th Cir. 1950); Nelson Weaver Realty Corp. v. Commissioner, 307 F.2d 897 (5th Cir. 1962).

16. Commissioner v. Pittston Co., 252 F.2d 344 (2d Cir. 1958).

17. Commissioner v. Ferrer, 304 F.2d 125, 129 (2d Cir. 1962).

18. Surrey, *Definitional Problems in Capital Gains Taxation*, 1959 Tax Revision Compendium 1203, 1204.

19. *Ibid.* See also, Comment, *The P. G. Lake Guides to Ordinary Income: An Appraisal in Light of Capital Gains Policies*, 14 Stan. L. Rev. 551, 552 (1962).

20. Lucas v. Earl, 281 U.S. 111 (1930); Blair v. Commissioner, 300 U.S. 5 (1937); Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Eubank, 311 U.S. 122 (1940); Harrison v. Schaffner, 312 U.S. 579 (1941).

ventory, stock in trade, and property held for personal use or consumption.[21] In 1924 there were deleted the affirmative requirements that the property be acquired and held for profit or investment.[22] The reason for the deletion was to insure that property held for personal use or consumption would be treated as a capital asset.[23] The effect of the 1924 changes was to make all property a capital asset unless specifically excepted from that category, and this is the present statutory approach.

The Congressional history as to the policy behind the capital gains provisions parallels the statute in its skimpiness. The report of the House Ways and Means Committee which recommended enactment of the initial capital gain provisions in 1921 stated:

> The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law.[24]

The original purpose of Congress seems to have been: (1) to relieve taxpayers of the impact of progressive tax rates on "bunched income"; that is, gain accrued or which will accrue over several years and realized in a single year, (2) to encourage conversions of capital investments into cash so that the tax on the gain could be collected; that is, to reduce the "lock-in" effect of taxes, and (3) to promote economic growth by encouraging taxpayers to risk their funds in capital investment.[25] This last purpose seems clear from the original definition of a capital asset as "investment" property.[26]

Although Congress may have had some temporary purpose to provide relief from progressive tax rates on "bunched income" through the capital gains provision, such policy is of minimal importance today. That the bunching problem is not a central purpose of the capital gains provision is evidenced by Internal Revenue Code section 1222(3) which fixes the holding period for long term capital gain at a less than annual period (of more than six months). Thus capital gain treatment is available although there is no "bunching" of more than one year's income. Further evidence is the relief from bunching provided by the averaging provisions, which have been present in the Code for many years,

21. Revenue Act of 1921, ch. 136 § 206(a)(6), 42 Stat. 233. See Silverstein, *The Capital Asset Definition*, 1959 Tax Revision Compendium 1285; Comment, *supra* note 19, at 552.
22. Revenue Act of 1924, ch. 234 § 208(a)(8), 43 Stat. 263.
23. 65 Cong. Rec. p. 2842 (1924), Comment, *supra* note 19, at 552.
24. H.R. Rep. No. 350, Part 1, 67th Cong., 1st Sess. 10-11 (1921).
25. Comment, *Distinguishing Ordinary Income from Capital Gains Where Rights to Future Income Are Sold*, 69 Harv. L. Rev. 737, 741 (1956); Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation*: I, II, 59 Yale L.J., 837, 1057, 1068 (1950); Comment, *supra* note 19, at 559; H.R. Rep. No. 2333, 77th Cong., 2d Sess. (1942), reprinted in 1942-2 Cum. Bull. 372, 396.
26. See text accompanying note 21 *supra*.

currently embodied in sections 1301-1305. Also, Congress has expressed its intent not to prefer income simply because it is bunched in excluding from capital assets "a copyright, a literary, musical, or artistic composition, or similar property" held by the creator.[27]

The other implications of the above statement of the Ways and Means Committee, that is, that capital gain policies are concerned with inducing capital investment and capital mobility; seem to be the fundamental congressional policy in enacting the capital gains provisions. The committee report for the revenue bill of 1963, as passed by the House, increasing the preferential treatment for certain capital gains emphasized there was the need for "unlocking" capital investments in order to mobilize new sources of risk capital, and to provide the government with additional tax revenues.[28]

The Congressional policy then is to allow capital gains only for gains arising from the *disposition* of property, and, as is clear from legislative statements, the exclusions of Sec. 1221, and the more than six months holding period requirement of Sec. 1222(3), only if the property is "investment" property. No preferential treatment is provided for sales of "business property,"[29] or for recurring receipts such as salary, rents or interest,[30] whether received in the normal course or in a lump sum.[31] This policy accords with the commonly accepted notion that there is no need to offer tax inducement to the normal use of property to produce income, or for one to offer his personal services for compensation.[32] There is no real practical choice to withhold from the market one's personal services. However, there is a choice between selling an investment and holding it for its income, with the possibility of avoiding tax on any appreciation altogether if the property is held until death.[33]

The landmark decisions of the United States Supreme Court in this area agree in general principle with the intent of Congress shown by the legislative history. These decisions will later be discussed in detail and are now presented in broad outline as part of the background to later discussion.

In *Burnet v. Harmel*,[34] there was taxed as ordinary income a large bonus paid to the grantor of an oil lease upon the signing of the lease. The Court analogized the payment to a prepayment of rent, and held that it was not to be within the intent of Congress ". . . to relieve the taxpayer from . . . excessive tax

27. Int. Rev. Code of 1954, § 1221(3). The committee reports accompanying the proposal for this provision indicate an intent to close a "loophole" allowing capital gain treatment for bunched income from personal effort. S. Rep. No. 2375, 81st Cong., 2d Sess. 43 (1950). See also, Comment, *Distinguishing Ordinary Income from Capital Gains Where Rights to Future Income Are Sold*, 69 Harv. L. Rev. 737, 740 (1956).

28. H.R. Rep. No. 749, 88th Cong., 1st Sess. 96 (1963).

29. Int. Rev. Code of 1954, §§ 1221(2), (3), (4). But see § 1231, which allows capital-gains-ordinary-loss treatment for property which is a business investment, and §§ 1245 and 1250 modifying this treatment.

30. Silverstein, *supra* note 21, at 1288, discussing S. Rep. No. 1567, 75th Cong., 3d Sess., p. 20 (1938).

31. Int. Rev. Code of 1954, §§ 1221(3), (4).

32. Comment, *supra* note 27, at 742; *But see* Miller, *supra* note 25, at 1076.

33. Int. Rev. Code of 1954, § 1014.

34. 287 U.S. 103 (1932).

burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions."[35] Somewhat similar reasoning was employed in *Hort v. Commissioner*[36] where an amount received by a lessor upon cancellation of a long-term lease was held to be ordinary income in the nature of "future rentals." In *Commissioner v. Gillette Motor Transport, Inc.* [37] the Court denied capital gain treatment to lump sum compensation received for the use of transportation facilities during World War II. Holding the taxpayer had received a payment in the nature of rent, the Court noted that not all "property" qualifies as a "capital asset." That term, stated the Court, "is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year."[38] The principle was phrased in the *Burnet v Harmel* manner in *Commissioner v. P. G. Lake, Inc.*[39] where the sale of a "carved-out" oil payment was held to result in ordinary income.

The principle, as stated by the Court, recognizes the intent of Congress to relieve taxpayers from the "bunching" hardship. Yet, although bunching was involved in all of the above cases, relief was denied because the receipt involved does not "ordinarily"[40] produce such hardship, or the right surrendered is not the "type"[41] which gives rise to the hardship intended. Bunching, therefore, is not relevant to capital gains purposes unless it is coupled with the "conversion of capital investment,"[42] or, the same idea differently expressed, arises "in situations typically involving the realization of appreciation in value . . . ."[43]

The emphasis in the above decisions is on the Congressional policy to favor only gains arising from "realized appreciation in value" as distinguished from periodic anticipation of recurring receipts. The intent of Congress not to prefer certain "business" property although there is realized value appreciation is reflected in the Court's decision in *Corn Products Refining Co. v. Commissioner.*[44] There the Court denied capital gain treatment to gain arising from dealing in corn futures where the futures were purchased by the taxpayer to protect itself against rises in the price of raw corn. Although the Court could have reached this result simply by analogizing corn futures in the hands of a corn products manufacturer to inventory or stock in trade, the decision was placed on the

35. *Id.* at 106.
36. 313 U.S. 28 (1941).
37. 364 U.S. 130 (1960).
38. *Id.* at 134.
39. 356 U.S. 260 (1958).
40. Burnet v. Harmel, 287 U.S. 103, 106 (1932).
41. Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 135 (1960).
42. Burnet v. Harmel, 287 U.S. 103, 106 (1932).
43. Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960).
44. 350 U.S. 46 (1955).

broader ground that the purchases of futures constituted "an integral part of [taxpayer's] manufacturing business."[45]

> Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss.[46]

This principle creates the possibility of treating certain property used in business as an ordinary asset despite the fact that it is neither stock in trade or held for sale to customers, nor real or depreciable property.[47]

III. The Assignment of Income Cases

The first and most important of the assignment of income cases decided by the United States Supreme Court is *Lucas v. Earl*[48] where it was held that a husband could not shift his income to his wife by way of a contract giving her title to one-half the earnings as a joint tenant. The Court, in an opinion by Justice Holmes, held that one who earns income cannot escape the tax by "anticipatory arrangements . . . by which the fruits are attributed to a different tree from that on which they grew."[49]

The fruit-tree metaphor seems to carry the court beyond the point it needed to reach. The graduated rate structure of the income tax was protected by the holding that salaries are to be taxed to those who earn them. This result is sensible and, most important, is based squarely on reasons of taxation. Justice Holmes' horticultural dictum, however, introduced into the tax law a property concept which has no direct relation to tax policy. As Professor Brown has stated it: "Judges perhaps more at home with common law ideas than with Revenue Acts have turned to search for a property concept which could constitute a tree capable of being transplanted. If they could discover an income producing 'tree,' capable of being transplanted and which had been transplanted or transferred, then the deflection was successful. If no tree or no transplant, then no deflection."[50] Thus, a right merely to future income is not property; but the asset which produces the income is property. An assignment of the former will not shift the tax; an assignment of the latter will.

This distinction was clearly made seven years after the decision in *Lucas v.*

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45. *Id.* at 51.
46. *Id.* at 52.
47. See generally, Chirelstein, *Capital Gain and the Sale of a Business Opportunity: The Income Tax Treatment of Contract Termination Payments*, 49 Minn. L. Rev. 1, 36-43 (1964).
48. 281 U.S. 111 (1930).
49. *Id.* at 115.
50. Brown, *The Growing "Common Law" of Taxation*, 13 U. So. Cal. Tax Inst. 1, 15 (1961). Professor Brown admonishes: "Beware the metaphor! Of all the anodynes for the pains of thought, it is the most seductive, the most misleading." For more unfriendly remarks about the metaphor see Rice, *Judicial Trends in Gratuitous Assignments to Avoid Federal Income Taxes*, 64 Yale L.J. 991 (1955). Other commentators find the metaphor useful. Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case*, 17 Tax L. Rev. 295 (1962).

Earl when, in *Blair v. Commissioner*,[51] the Court held there had been a shifting of the tax to the assignee where the life beneficiary of a trust assigned his beneficial interest. This, held the Court, was not simply the assignment of a "chose in action." The life beneficiary was the owner of an equitable interest in the trust corpus and had assigned the "right, title and estate in and to property."[52] And so the search had begun for "property" as distinguished from a mere "chose in action" or "income interest" in the property. Non-tax lawyers might wince at the suggestion that a right to future income is not property. But in *Blair* that word was obviously being used in the sense of "property which produces the income." Although the life beneficiary was the owner of the income interest, and in that sense had assigned only a right to future income, it was held he had assigned an income producing asset, and therefore "property" because the life estate is an equitable interest in property.

Because the taxpayer in *Blair* had made an assignment of his entire interest, that is, an assignment of the income for his life, perhaps the Court felt that there was not involved a tax avoidance device. The assignment for life is a substantial price to pay in order to avoid taxes and will not readily be resorted to. Such a rationale is more germane to the import of the taxing statutes than is the "property" approach. The fact that a life interest in a trust is an equitable interest in property seems unrelated to the question of whether the assignor may shift the tax on the receipts. This approach requires the Court to make a distinction between an equitable interest in property and a simple chose in action for money, a distinction which has no apparent basis in capital gains policy. Most important, the property approach camouflages the fact that what the life tenant owns is indeed only the right to future income. His bundle of rights consists of no more than the right to income, and to compel the trustee to pay or account for the income; and the income producing property—the tree if you will—is the corpus.[53] The Court itself recognized this fact, albeit in another context, in *Irwin v. Gavit*,[54] where it was held that amounts received by a beneficiary of a testamentary trust, although property, were taxable income and not bequests exempted by statute: ". . . the provision of the act that exempts bequests assumes the gift of a corpus and contrasts it with the income arising from it, but was not intended to exempt income property so-called simply because of a severance between it and the principal fund."[55] In so distinguishing between the income producing corpus and the income interest, the Court rejected the position of the dissent that: "Money, of course, is property . . . . It was a gift by will,—

51. 300 U.S. 5 (1937).
52. *Id.* at 13-14.
53. Note, 50 Yale L.J. 512, 516 (1941); Surrey, *Assignments of Income and Related Devices: Choice of the Taxable Person*, 33 Colum. L. Rev. 791, 801 (1933). Note also the provisions of the Internal Revenue Code which treat the life tenant as in the income shoes of the remainderman, section 102(b) taxing to the life tenant income acquired by gift, bequest, devise or inheritance; section 273 disallowing amortization of a life estate acquired by gift, bequest or inheritance.
54. 268 U.S. 161 (1925).
55. *Id.* at 167.

a bequest . . . . The money here sought to be taxed was not the fruits of a legacy; it was the legacy itself."[56]

But the *Blair* doctrine was not to be carried too far. In *Helvering v. Clifford*,[57] the income of a trust payable to the taxpayer's wife was held taxable to the taxpayer-grantor because of the short term of the trust, the grantor's retained powers over the corpus, and the fact that his wife was the beneficiary, although no support obligation was being discharged. The transfer was in the nature of a temporary shifting of income with no passing of substantial rights over the income producing property. Therefore, the transfer was treated as an assignment only of the income interest and not of the underlying property.

In *Clifford*, the Court stated that there was no need to rely on the rule of *Lucas v. Earl*.[58] Although the device used by the taxpayer in *Clifford* is simply another way of avoiding the progressive tax on income while substantially retaining the corpus, the Court, while holding against the taxpayer, apparently saw the case as different from an assignment of future income problem. However, in *Helvering v. Horst*,[59] which held that the owner of a coupon bond could not shift the tax on bond interest by assigning the interest coupon to his son before the due date, the Court relied on *Lucas v. Earl* stating that income is to be taxed ". . . to him who earns, or creates and enjoys it . . . . Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions . . . . [T]he fruit is not to be attributed to a different tree from that on which it grew."[60]

On the day the *Horst* case was decided, the Court also decided *Helvering v. Eubank*[61] where an assignment of future renewal commissions payable for the past services of a life insurance agent in writing policies was held not to shift the tax. Relying on *Horst*, and extending *Lucas v. Earl* to a situation where no further services were required, the assignor was held taxable on the commissions.

In *Harrison v. Schaffner*,[62] the *Blair* rule was limited when its benefit was refused to a life beneficiary of a trust who assigned dollar amounts of the trust income for a year following the assignment. In so doing the Court was required to reject the argument of the taxpayer that under the *Blair* doctrine there had been a conveyance of an equitable interest in property.[63] Refusing to be troubled by "the logical difficulties of drawing the line between the gift of an equitable interest in property for life effected by a gift for life of a share of the income of the trust and the gift of the income or a part of it for the period of a year as in this case,"[64] the Court decided the case simply on the ground that "taxation is

56. *Id.* at 168-69.
57. 309 U.S. 331 (1940).
58. *Id.* at 338.
59. 311 U.S. 112 (1940).
60. *Id.* at 120.
61. 311 U.S. 122 (1940).
62. 312 U.S. 579 (1941).
63. *Id.* at 583.
64. *Id.* at 583.

a practical matter"[65] and since the assignor had given up rights of so little substance, the Court would not, simply because the transfer was a disposition of "property," allow "the form to obscure the reality."[66]

So it appears that what "in reality" is "property" in *Blair* becomes "not really" "property" in *Schaffner*, the difference being not the qualitative nature of the interest transferred, but the factor of tax avoidance. The nub of the problem, of course, is the inherent weakness of the *Blair* dichotomy between "property" and "income," which is so firmly rooted in the "fruit-tree" metaphor.

IV. Judicial Construction of the Word "Property" in the Capital Asset Definition

In the foregoing cases, the Supreme Court was faced with the problem of preventing avoidance of the progressive tax rates. The cases turned upon a distinction made between transfers of "property" and transfers of "future income." The Supreme Court, and, following its lead, the lower courts, have thought the same distinction to be controlling in cases where the issue is not the choice of a taxable person, but the nature of the income—capital gains or ordinary income.

The Lease Cancellation Cases

The transplant of the "fruit-tree" analysis into the capital gains area occurred in *Hort v. Commissioner*.[67] There the Court taxed as ordinary income a lump sum payment received by a lessor from his lessee upon cancellation of the lease. The court assumed that the lease was "property," but, analogizing to the interest coupon in *Horst*, it held that the lump sum payment was not a return of capital but ". . . essentially a substitute for rental payments which . . . must be regarded as ordinary income. . . ."[68]

But it proves nothing to say that gain is not capital gain merely because it is essentially a substitute for future ordinary income. Or, it might be said that it proves too much. Such a view would make every sale of property give rise to ordinary income. The amount received on a sale of a share of stock is in large part the value of the future dividends to be paid upon the stock. The gain received on a sale of a bond is attributable to the excess of the bond interest rate over the current market rate, which would have been received by the bond holder as ordinary income had he not sold the bond.[69] Thus the future ordinary income

65. *Id.* at 582.
66. *Id.* at 583.
67. 313 U.S. 28 (1941).
68. *Id.* at 31.
69. United States v. Dresser Indus., Inc., 324 F.2d 56 (5th Cir. 1963). The Court addressed itself to this point at 58:

> But we feel that the broad assertion made that, in any case where the purchase price includes anticipated income there can be no capital gains treatment, must be answered . . . . As a legal or economic position, this cannot be so. The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income. The value of a vending machine, as metal and plastic, is almost

rationale is self-defeating in the capital gains area. It may be somewhat useful in the assignment of income cases, such as *Horst,* where the purpose of the rule is to prevent the shifting of income tax among related taxpayers except at the cost of giving up a substantial quantum of rights in the income producing property. This purpose is well served by refusing to give tax effect to temporary reallocations of future income where the taxpayer has retained a substantial present reversion or given up his rights only for a short period.[70] Thus, in *Horst,* the retention of the bond prevented the shifting of the tax on the assigned interest coupon. The retained bond was a clear indication that an insufficient quantum of rights had been transferred to allow shifting of the tax. Hence, the "property" was retained and only "future income" was transferred. Put in terms of capital gains policies, the retention of a reversion after a transfer may indicate there has been no termination of one's interest in an asset; no "conversion" of the investment. This seems to be the way the Court viewed the lessor's receipt in *Hort*—the same as a prepayment of rent at the inception of the lease.[71] Had this been the case, *Horst* would be persuasive authority since there would have been no termination of interest in any asset.[72] However, in *Hort* the lessor did terminate his interest in the lease. Also, he did not receive the payment from the lessee as rent, but for the appreciation in value of the lessee's commitment in the lease. The lessee paid no part of the money for rent as he was no longer to occupy the premises. The payment was made in return for a release from a promise to pay a specified rent because that obligation was no longer bringing the tenant a favorable return; the rental value of the premises had depreciated for the tenant, which brought about a corresponding appreciation of the value of the lease to the lessor. For example, suppose a lease calls for a periodic rental of 1000 dollars and the rental value of the premises declines to 900 dollars. The lessor now owns a lease with a premium value; that is, with a value quite independent of the value of the underlying real estate. A payment by the lessee in cancellation of the lease will be in an amount reflecting the difference between the present value of the unmatured rental payments and the fair

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nil; its value arises from the fact that it will produce income.

At common law, the right to receive income from land was ownership of the land. Lord Coke said: "If a man seized of land in fee by his deed granteth to another the profits of these lands, to have and to hold to him and his heirs, and maketh livery *secundum forman chartae,* the whole land itself doth pass. *For what is land but the profits thereof?*" Co. Lit. 45 (Emphasis added.)

Zarky, *Capital Gain Concepts: What is a "Capital" Asset? When is there a "Sale or Exchange"*?, 11 U. So. Cal. Tax Inst., 357, 372 (1959). "In a sense, every sale of property is a commuted realization of the future income which can be earned, a conclusion which seems fairly evident where the asset is self-liquidating or of wasting nature, but is no less true of depreciable property or even of land itself. Thus, the line to be drawn between transfers of income and of income-producing property itself, is not always a simple one to discern."

70. Compare Int. Rev. Code § 673, which allows the tax to be shifted upon a transfer in trust of more than 10 years, and Rev. Rul. 38, 1955-1 Cum. Bull. 389, following *Blair* with respect to a transfer by a trust beneficiary of trust income for a period of at least 10 years.

71. 313 U.S. at 30.

72. See cases cited in note 118, *infra.*

rental value of the property for the unexpired term of the lease; that is, the present value of 100 dollars for the unexpired period of the lease. Such payment represents appreciation in value of the lease. Thus, in *Hort*, upon the cancellation the landlord received back his original capital, the land free of the lease, together with his gain, the value of the appreciation in the promise to pay rent due to a decline in the rental market. The lessor was not engaging in the periodic anticipation of future rentals. He was completely terminating his interest in a valuable asset which was separate and distinct from the reversion—the lease.

As one writer has pointed out,[73] it is difficult to see, except for the reversion owned by the lessor, how his position is different from the owner of a bond which has appreciated due to a general decline in the market rate of interest. Upon a sale of the bond, he receives back his original investment together with an amount reflecting the present value of the difference between the stated interest rate and the current market rate. Both the lessor and the bondholder have invested capital in a promise—the bondholder in a promise to pay a stated interest; the lessor in a promise to pay a stated rent.[74] Each has converted his investment and in each case there has been received back the original investment together with gain due to the appreciation of the promise. Both gains seem to be within the capital gains policies; yet, the bondholder will receive capital gain and the lessor will receive ordinary income, apparently because of the presence in the lessor of a reversion. Thus, suppose that in *Hort* the landlord had sold the fee in the real property. The amount received which is attributable to the favorable lease would clearly be capital gain, although entirely attributable to appreciation in the value of the promise to pay rent and in no wise attributable to the value of the real estate independent of the lease. The reason for denial of capital gain in *Hort* seems to be the retention of the reversion, a factor which seems clearly irrelevant where the lease has a value independent of the value of the reversion.[75]

73. Chirelstein, *supra* note 47, at 27-29, 31.

74. By entering the lease, the lessor submitted his capital to an investment risk, *i.e.*, that the value of the rental market would rise, in return for the recurring receipts in the nature of rent together with the counter-balancing chance that the rental market would decline and his lease would appreciate. See Chirelstein, *supra* note 47, at 27-29. *Cf.* Comment, *supra* note 27, at 742-43 (1956). His situation is analogous to the purchaser of a bond who submits to a risk that the interest rate will rise in return for recurring interest payments together with the counter-balancing chance that the interest rate will fall and the bond appreciate. In both situations any gain received on sale is due to the appreciation in value of the asset. Chirelstein, *supra*.

75. Continuing with the effect of a retention of the reversion in *Hort*, and the comparison by the Court with the *Horst* situation, suppose that in *Horst*, the bond contained a stated interest rate of 5%, the market dropped to 4%, and the obligor renegotiated with the bondholder the interest rate so that in consideration of a lump sum payment the bond would thereafter carry only a 4% rate. It seems clear that the payment to the bondholder should be capital gain in spite of the fact that the bondholder has retained the bond and has sold simply the appreciated element in the promise to pay interest, and even though, had that appreciated element been received over the life of the bond it would have been ordinary income. It should not matter that the bondholder continues to hold the underlying bond and receives a reduced rate of interest. Essentially what he has done is to sell the 5% bond in return for his original capital together with the present value of 1% for the life of the bond, and then reinvested his capital in a 4% bond. In a sense, the owner of the real property in *Hort* could be said to be in an identical position, *i.e.*, could be treated as having

The influence of *Horst* seems to have caused the presence of a reversion in the lessor to lead to a finding by the Court of no "closed transaction,"[76] that only "income" and not "property" had been transferred.

Following *Hort* the authorities of course hold that upon the cancellation of a lease, gain to the lessor is ordinary income in the nature of a substitute for rent.[77] In *Spray Water Power and Land Co.*,[78] a lessor released his lessee from a 999 year lease, requiring payment of 2000 dollars a year for a daily supply of water. Although the Tax Court ultimately relied upon the "substitute for rental payments" rationale of *Hort*, the emphasis of the opinion was on the fact that cancellation of a lease, at least in so far as the lessor is concerned, is not a "sale or exchange" because there is nothing "transferred." The lessor sells merely a release from the obligation to pay rent and consequently, there is no transfer to the lessor of anything which can survive in his hands. The rights of the parties "merely come to an end and vanish . . . ."[79] Since a cancellation is not a sale, reasoned the Tax Court, the payment to the lessor was a substitute for rental payments under *Hort*, and thus ordinary income.[80]

Although the thrust of *Hort* seems to be toward the definition of "property," there is some language in the opinion which might be read as going to the issue of "sale or exchange": "The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises."[81] A reading of *Hort* as involving the issue of "sale or exchange" seems strained and would appear to be an attempt to avoid the problem of defining "property." However, a holding of no "sale or exchange" because the right or asset transferred does not survive in the hands of the transferee seems to be merely another way to define "property"—as "an asset which survives the transaction,"—a definition which is in no way related to the intent of Congress as expressed either in the legislative history or as understood by the Supreme Court. Moreover, this approach ignores the fact that the lessor does obtain something he did not have before the cancellation, albeit not the lease itself—the land free of the lease together with an amount representing the value appreciation of the lessee's commitment to pay rent. Common understanding seems to indicate that there has been a sale of "property," characterized by one court in a case involving a lease favorable to the lessee as "the right freely to lease."[82] However termed, a corresponding right

sold the real property for an amount equal to the value of the realty plus the value of the appreciated lease, and then having bought identical realty without such a lease. The difference between the selling and purchase price should be capital gain.

76. 313 U.S. at 33.

77. Treas. Reg. § 1.61-8(b) (1957), Spray Water Power & Land Co. v. Commissioner, 20 T.C.M. 353 (1961).

78. 20 T.C.M. 353 (1961).

79. *Id.* at 356.

80. *Id.* at 357; Allen v. First Nat'l Bank & Trust Co. in Macon, 157 F.2d 592, 593 (5th Cir. 1946), *cert. denied*, 330 U.S. 828.

81. 313 U.S. 28, 32 (1941).

82. Commissioner v. Ray, 210 F.2d 390, 392 (5th Cir. 1954), *cert. denied*, 348 U.S. 829 (1954). In *Ray*, the lessee was paid for cancellation of a clause in the lease preventing the

was sold in *Hort* by the lessor to the lessee. The issue *should* be whether such property is a capital asset.[83]

Where the cancelled lease is favorable to the tenant because of a rise in the rental market, both the "sale or exchange" and "property" issues have been decided in favor of the tenant and a payment by the lessor to the tenant in cancellation of the lease gives the tenant capital gain.[84] In *Walter H. Sutliff*,[85] where the lessee sold his interest not to the lessor, but to a third person, it was held that the *Hort* principle did not apply since the tenant neither received anything on account of future rent; nor was he the owner of the fee. In *Commissioner v. Golonsky*,[86] the Commissioner's position that a "cancellation or termination" is not a sale was rejected, the Court noting that the amount paid to the lessee must be amortized by the lessor over the life of the lease.[87] In other words, the

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landlord from leasing other parts of the building to competitors of the lessee. Rejecting the position of the Commissioner that there was no sale because upon cancellation the restrictive covenant vanishes, does not survive in the hands of the lessor, and thus cannot be the subject of a sale, the Court adopted the following position:

> A sale in the ordinary sense is a transfer of property for a fixed price in money or its equivalent. Examine the circumstances here, the precedent condition, the transaction and the subsequent condition. Before the transaction the taxpayer had a valuable property right, intangible but nonetheless property, a restrictive covenant in his lease [imposing a servitude on the property] which prevented competition in his trade or business. Before the transaction [which freed the property from this servitude] the lessor lacked a valuable right, the right to lease its premises to whomsoever it chose upon whatever terms it could arrange [and to sell it free of the servitude]. True it had once possessed this right, but it had conveyed the right for a consideration to the taxpayer. In the transaction the lessor gave its $20,000 to the taxpayer and in exchange the taxpayer gave to the lessor what it had not immediately theretofore possessed, the right to lease its premises to whomsoever it chose at whatever terms it could arrange.
>
> The Commissioner's position apparently depends upon a view that the restrictive covenant when transferred or released to the covenantor simply disappears, vanishes and becomes nothing and, therefore, cannot be the subject of a sale. The concept, it seems, overlooks the substantial fact that it is the right freely to lease that is the subject of the transaction. Intangible though the property may be, it is real and valuable to both parties to the transaction [a servitude imposed by] a restrictive covenant in the hands of the taxpayer, [an unburdened], a freely exercisable right in the hands of the lessor. The commissioner's view conceives the covenant as the thing and ignores the status of the intangible right [the servitude it imposes] involved as the substance of the sale. . . . In the commissioner's view property rights which disappear or, as he expresses it, vanish upon a relinquishment, surrender or transfer cannot be the subject of a sale even though the transfer or surrender or relinquishment for a consideration is that which, [by reuniting servient and dominant estate] effects the vanishment. There is much authority to the contrary [of these views].

210 F.2d at 391-92.

83. Disenchantment is setting in with the purely technical requirement of a sale or exchange that a property interest survive the transaction. See text accompanying notes 254-59, *infra*.

84. Walter H. Sutliff, 46 B.T.A. 446 (1942); Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953); Commissioner v. Ray, 210 F.2d 390 (5th Cir. 1954), *cert. denied*, 348 U.S. 829 (1954); Metropolitan Bldg. Co. v. Commissioner, 282 F.2d 592 (9th Cir. 1960); *Cf.* Rev. Rul. 60-4, 1960-1 Cum. Bull. 303, holding that a lease held by one who sub-leased the property and was not a dealer in leases was a § 1231 asset because it had more than thirty years to run and thus was "real property" used in the trade or business; Voloudakis v. Commissioner, 274 F.2d 209 (9th Cir. 1960).

85. 46 B.T.A. 446 (1942).

86. 200 F.2d 72 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953).

87. *Id.* at 74.

lease is "acquired" by the lessor and "survives" the transaction. Also, in holding the lease to be "property"[88] heavy reliance was placed upon the cases, direct descendants of *Blair*, holding that a transfer by a life tenant of his interest in a trust is a transfer of a capital asset.[89] *Hort* was distinguished because the lessee received no money on account of rent.[90] The same result obtained in *Commissioner v. McCue Bros. & Drummond, Inc.*,[91] the Court distinguishing cases dealing with the release of exclusive agency contracts[92] where no sale or exchange was found because the contractual right was not transferred, but was released and merely vanished. A lease, said the Court, is a more substantial property right which does not go out of existence upon a transfer whether the transfer be to a third person or to the lessor.[93] *Hort* was again distinguished upon the ground that the payment to the lessee does not represent future rentals.[94] In *Commissioner v. Ray*,[95] where a non-competition clause in a lease was cancelled, the Fifth Circuit completely rejected the Commissioner's position that since the restrictive covenant did not survive the transaction there was no "sale." The Court adopted for its holding the argument of the taxpayer that the "right to lease" is the subject of the transaction and that this right was transferred by the cancellation.[96] In *Metropolitan Building Co.*[97] two transactions were involved. Taxpayer was a lessee and in one transaction cancelled a portion of the lease with his lessor, the sub-tenant paying for the cancellation. Although the underlying leasehold had been cancelled, the Tax Court held that the gain to the taxpayer was ordinary income since the value of the leasehold was entirely attributable to the sub-lease, and, reasoned the Court, taxpayer had merely received a substitute for future rents payable under the sub-lease. *Hort* therefore controlled.[98] In the second transaction, the taxpayer sold his entire remaining leasehold interest, including the sub-leases, to a third party for a lump sum consideration. The gain was held to be capital gain even though the lease had only ten months to run, and the sales price was based upon the net rentals due under the sub-leases. The Tax Court refused to apply *Commissioner v. P. G. Lake, Inc.*,[99] then recently decided, on the ground that taxpayer had retained no

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88. *Id.* at 73, 74. See also, Rev. Rul. 60-4, 1960-1 Cum. Bull. 303, which holds that a lease held by one who is not a dealer in leases is a section 1231 asset because it had more than thirty years to run and thus was "real property" used in the trade or business and capital gain was allowable on its sale.

89. Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943); McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947).

90. Lipsitz v. Commissioner, 220 F.2d 871, 874 (4th Cir. 1955).

91. 210 F.2d 752 (2d Cir. 1954), *cert. denied*, 348 U.S. 829 (1954).

92. See text accompanying notes 238-326, *infra*.

93. 210 F.2d at 753.

94. *Ibid.*

95. 210 F.2d 390 (5th Cir. 1954), *cert. denied*, 348 U.S. 829 (1954).

96. *Id.* at 392.

97. 31 T.C. 971 (1959) *acq.*, 1959-2 Cum. Bull. 6, *rev'd, in part*, Metropolitan Bldg. Co. v. Commissioner, 282 F.2d 592 (9th Cir. 1960).

98. 31 T.C. at 977-78.

99. 356 U.S. 260 (1958).

reversion in the property.[100] It also rejected the argument that an ordinary income result was called for because the amount received was based upon the future rentals to be produced by the sub-leases: "[T]he earning power of the income-producing property will almost always be a factor determining its fair market value."[101]

The Tax Court's treatment of the two transactions in *Metropolitan Building Co.* seems inconsistent. Gain from both transactions was attributable to the anticipated rentals from the sub-leases. The difference in result is apparently based only on the fact that payment in the first transaction had been made by the sub-tenant rather than the lessor. On appeal[102] the Tax Court was reversed as to its holding on the first transaction, the Court holding that the controlling fact was the transfer of the leasehold in its entirety rather than the person of the payor.[103] The gain from both transactions was capital gain.

In summary, cancellation of a lease gives capital gain to the lessee and ordinary income to the lessor. The influence of *Horst* makes the difference in treatment seem to turn solely upon the fact that the lessor also owns the reversion in the property. For this reason he is held to receive payments in the nature of future rents and not to have sold "property," which is also expressed in the rationale that there has been no "sale or exchange." However, the "future income" analysis does not distinguish the situation of the lessee from that of the lessor. The future income rationale in *Hort* is based merely on the fact that the receipt represents the value of future rents, which, on receipt, would be ordinary income. The receipt by the lessee on the cancellation of a lease is also "future ordinary income" in that it represents the absence of a cost item which will be reflected in the amount of ordinary business income which would not have been offset by a rent deduction. Furthermore, where as in *Metropolitan Building Co.* the lessee is also in the position of the landlord because he is in turn sub-leasing the property, the cancellation of his lease does give him gain which in the *Hort* sense is future ordinary income. But as *Metropolitan Building Co.* indicates, that fact by itself makes no difference and the lessee is given capital gain. Clearly then, the "future income" rationale is also irrelevant to the nature of gain to the lessor. Recognition of this fact will permit focus on the issue of whether the lessor has converted an investment.

With regard to the sale or exchange issue, the courts, except for *Ray*, have made the difference in treatment between the lessor and lessee depend upon property notions. Because the lease transfer to the landlord is a traditional property interest and "survives" in the hands of the landlord rather than vanishing or terminating, it is held there has been a sale of property. Since 1954, a lessee is guaranteed "sale or exchange" treatment by section 1241. However, a payment to the lessor for cancellation is a payment merely for the release of

100. 31 T.C. at 980.
101. *Ibid.*
102. Metropolitan Bldg. Co. v. Commissioner, 282 F.2d 592 (9th Cir. 1960).
103. *Id.* at 594.

the obligation to pay rent; a termination, an extinction, with nothing surviving in the hands of the lessor. That preferential taxation, which is based upon the conversion of a long time investment, should turn upon such a property concept seems improper, and, as will be seen in the cases dealing with exclusive agency and distributorship contracts, it is being less and less stressed by the courts.[104]

"Carved-Out" Interests: The P. G. Lake Doctrine

The Supreme Court continued its "future ordinary income" rationale in *Commissioner v. P. G. Lake, Inc.*[105] where the owner of a working interest in oil and gas leases sold an oil payment right[106] of 600,000 dollars in consideration of cancellation of a debt in that amount. At the time of the sale it was reasonably certain that the oil payment right would pay out in three or more years and it did in fact pay out in a little more than three years. The Court, stating that the capital gain provisions are to be narrowly construed "to relieve the taxpayer from excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions,"[107] held the receipt to be ordinary income.

> We do not see here any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. The pay-out of these particular assigned oil payment rights could be ascertained with considerable accuracy.[108]

The Court emphasized the "future income" rationale:

> The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of

104. See text accompanying notes 254-59, *infra*.

105. 356 U.S. 260 (1958).

106. The Supreme Court described the terms "working interest" and "oil payment" as follows:

> An oil and gas lease ordinarily conveys the entire mineral interest less any royalty interest retained by the lessor. The owner of the lease is said to own the "working interest" because he has the right to develop and produce the minerals.
>
> In Anderson v. Helvering, 310 U.S. 404, we described an oil payment as "the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced. *Id.* at 410. A royalty interest is "a right to receive a specified percentage of all oil and gas produced" but, unlike the oil payment, is not limited to a specified sum of money. The royalty interest lasts during the entire term of the lease. *Id.* at 409.

356 U.S. at 261-62 n.1.

A further description of an "oil payment" is contained in Lyon & Eustice, *supra* note 50, at 302, n.35:

> The term is typically an *in rem* right to receive a stated fraction of oil produced from a property for a limited period of time or until a specified sum of money (or a specified number of barrels of oil) has been received. The term "carved out" means that the oil payment is sold by a person who retains an interest in the mineral property subject to the rights of the grantee of the oil payment. An oil payment may be carved out of a royalty interest, a working interest, or from a larger oil payment, with the grantor retaining in effect a reversionary interest in the property. The first two of these situations were present in *Lake* and were treated alike.

107. 356 U.S. at 265.

108. *Ibid.*

income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.[109]

The Court then went on to place heavy reliance upon *Clifford*, *Schaffner*, and especially on *Horst*, quoting extensively from *Horst* regarding "enjoyment of fruits" of labor or investment by disposing of the right of collection.[110]

The Court considered the interest sold as "fruit" rather than "tree" and therefore not a capital asset. This analysis, together with the Court's lengthy quotation of *I. T. 4,003*,[111] indicates an intent upon the part of the Court to embrace the Commissioner's position therein stated.[112] Under that position, assignment of an oil payment right, no matter how long or short lived it may be, which extends over a period less than the life of the property interest retained by the transferor is an assignment of future ordinary income and will not receive capital gain treatment. But, if what is assigned is not a "horizontal slice" but a so-called "vertical slice"—that is, the entire interest of the assignor in the property or a fraction of his interest extending over the entire life of the property—then a capital asset—the "tree," or a fractional part of it—will have been transferred.

By adopting the Commissioner's position and by its heavy reliance on the assignment of income cases, the Court is determining the meaning of "property" under Section 1221 by way of the "fruit-tree" metaphor. Capital gains treatment turns on whether or not the assignor retains a reversion in the property assigned. An assignment will receive capital gains treatment if it consists of the assignor's entire interest in the property even though that interest be merely an oil payment (e.g., the assignor sells his longer lived interest first while retaining an oil payment which he later sells; or, similarly, a purchaser of an oil payment

109. *Id.* at 266.
110. *Id.* at 267.
111. 1950-1 Cum. Bull. 10. *I.T. 4,003* states:
. . . the assignment of any in-oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income from such property interest. Therefore, the assignment for a consideration of any such in-oil payment right results in the receipt of ordinary income by the assignor which is taxable to him when received or accrued, depending upon the method of accounting employed by him. Where the assignment of the in-oil payment right is donative, the transaction is considered as an assignment of future income which is taxable to the donor at such time as the income from the assigned payment right arises.
Notwithstanding the foregoing, G.C.M. 24849, *supra*, and I.T. 3935, *supra*, do not apply [*i.e.*, capital gain will result] where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire life of the property.
1950-1 Cum. Bull. at 11.
112. The Tax Court, in strictly applying *Lake* in assigned oil payment cases, *Estate of O. W. Killiam*, 33 T.C. 345 (1959); *J. G. Dyer*, 34 T.C. 513 (1960), *aff'd*, 294 F.2d 123 (10th Cir. 1961); *Jay H. Floyd*, 20 T.C.M. 303 (1961), *aff'd per curiam*, 309 F.2d 95 (5th Cir. 1962), has noted the reliance of the Supreme Court on the Commissioner's position in *I.T. 4003* and has strongly implied that the Court has adopted that position as a test. *Estate of O. W. Killiam*, *supra*, at 348.

sells it for a gain thus assigning his whole interest), or if it consists of a vertically cut oil payment (a payment which pays out simultaneously with the retained fraction), or of the "tail end" fraction of a horizontally cut oil payment (a payment which pays out after the retained portion).[113] On the other hand, if the interest transferred is a "carve-out"; that is, an interest which is shorter lived than the interest which is retained and from which the assigned interest derives, then no capital asset has been transferred.

The result in *Lake* is undoubtedly correct. To allow capital gains for the sale of the oil payment would clearly have dealt a substantial blow to the ordinary income status of oil royalties. However, to rationalize the result on the "future ordinary income" theory is dangerous in the other direction since, carried to its logical extremes, that doctrine would signal the end of capital gains on the sale of any property. As recognized by the Court in *Lake*, Congress intended capital gain treatment only upon the conversion of a capital investment. The notion of "conversion" is usually expressed in the "sale or exchange" requirement.[114] A transfer of an insubstantial number of one's total bundle of rights in a physical asset is held not to be a sale but a lease or a license.[115] The transaction in *Lake* can be viewed as not having been a "sale or exchange." However, since there was a disposition of some interest in property,[116] the problem can also be approached in terms of whether what was disposed of was the taxpayer's "investment." Although the Supreme Court twice stated there had been no conversion of a capital investment,[117] its use of the "future ordinary income" rationale is confusing. The Court could simply have found that the taxpayer's investment in *Lake* was not in the oil payment; rather, it was in the working interest retained by the assignor. The oil payment in *Lake* has been analogized to the interest acquired by the lessee of real property who acquires merely the right to the use of the property for a limited period. A "sale" of the lease to the lessee by the owner of the fee is by no means a conversion of his investment in the real estate.[118] Likewise, in *Lake* there was only a single investment, in the working

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113. See generally, Lyon & Eustice, *supra* note 50, at 307-09; Simon, *Supreme Court Says No to Capital Gain Treatment of Carved-Out Oil Payments*, 37 Taxes 61, 62 (1959).

114. Int. Rev. Code of 1954, § 1222(3).

115. Lyon & Eustice, *supra* note 50, at 328.

116. See Commissioner v. Ray, 210 F.2d 390 (5th Cir. 1954), *cert. denied*, 348 U.S. 829 (1954), discussed in text accompanying notes 82, 95, 96, *supra*; McAllister v. Commissioner, 157 F.2d 235, 237 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1946).

117. 356 U.S. at 265, 268.

118. Lyon & Eustice, *supra* note 50, at 328; Chirelstein, *supra* note 47, at 29, 30; Burnet v. Harmel, 287 U.S. 103 (1932), and other cases cited in Lyon & Eustice, *supra*, p. 327, 328, notes 139-142; Aircraft Mechanics, Inc., 30 T.C. 1227 (1958); Theodore E. Moberg, 35 T.C. 773 (1961), *rev'd and remanded on other grounds*, 310 F.2d 782 (9th Cir. 1962); Kurlan v. Commissioner, 343 F.2d 625 (2d Cir. 1965).

The lessor is, of course, entitled to deductions for depreciation in order to replace the "wasting" of the premises in the hands of the tenant. The assignor of the oil payment recovers the "wasting" of his longer lived interest, due to production operations, through the depletion deduction.

The argument can be made that a sale of a lease to a lessee is a sale of the "investment" since the value of at least that portion of the investment in the real estate will be interest, which was not terminated by the sale of the oil payment. This situation is entirely different from that in *Hort*. There, the lessor was not engaging in the periodic anticipation of income from his investment in the real estate; on the contrary, he was entirely liquidating his investment in a quite different asset, the lease, which had a value independent of the realty due to a decline in value of the leased premises. In the *Lake* situation, the emphasis should be on the lack of termination of investment. In *Gillette Motor Transport, Inc.*[119] the Court made this point without confusing it with the "future ordinary income" rationale. Although it relied on *Lake* and *Hort* in holding that compensation for condemnation by the government of the use of taxpayers transportation facilities was ordinary income, the Court's emphasis was on the fact that no "investment" had been converted. Admitting that the right to use the transport facilities was "property," that right was not itself the investment.[120]

Another line of analysis suggested by the Supreme Court's reasoning in *Lake* is that of "investment risk."[121] The Court stressed that the pay out of the assigned oil payment rights could be ascertained with considerable accuracy and that in fact one such payment had been used to secure a loan of almost its face amount of ten million dollars.[122] The lack of any risk to the purchaser of the oil payment indicates absence of any investment having been sold or purchased. No funds had been placed "at risk."[123] Would the result in *Lake* have been otherwise if the assignor's retained interest had been unproved or speculative?

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used up by the lessee. Likewise with the oil payment in *Lake*; in a very real sense, the assignor sold a portion of the oil in place, which is in fact treated as an interest in land under local law. However, this reasoning would eliminate entirely from ordinary income treatment rents and royalties which are anticipated in advance of use or production. Therefore, the courts refuse to allow capital gains to one who periodically anticipates income without terminating his investment so as, *e.g.*, to *sell* for rent the *use* of the property for a day, a week, a month, etc. Furthermore, such reasoning could be self-defeating; in the above examples, it would lead to the result that the use of land and the oil in place would be "property held for sale to customers" which is excluded from capital gain treatment by Int. Rev. Code of 1954, § 1221(1).

119. 364 U.S. 130 (1960).

120. That right is not something in which respondent had any investment, separate and apart from its investment in the physical assets themselves. Respondent suggests no method by which a cost basis could be assigned to the right; yet it is necessary, in determining the amount of gain realized for purposes of § 117, to deduct the basis of the property sold, exchanged, or involuntarily converted from the amount received. § 111(a). Further, the right is manifestly not of the type which gives rise to the hardship of the realization in one year of an advance in value over cost built up in several years, which is what Congress sought to ameliorate by the capital-gains provisions . . . . In short, the right to use is not a capital asset, but is simply an incident of the underlying physical property, the recompense for which is commonly regarded as rent.

Id. at 135. Compare, Terminal S.S. Co., 34 T.C. 915 (1960); Rev. Rul. 58-296, 1958-1 Cum. Bull. 276; Rev. Rul. 61-18, 1961-1 Cum. Bull. 5; Weyerhaeuser S.S. Co. v. United States, 192 F. Supp. 615 (W.D. Wash. 1961).

121. "If 'investment' is the placing of funds at risk, the question of whether the taxpayer in selling a right has anticipated income or actually sold part or all of an investment would seem to depend on whether or not he has transferred a substantial risk to the buyer." Comment, 69 Harv. L. Rev. 737, 742-43 (1956).

122. 356 U.S. at 265.

123. See Lyon & Eustice, *supra* note 50, at 306.

This question arose in *Ortiz Oil Co.*,[124] decided long before *Lake*. The owner of oil leases on undeveloped property was held to have received capital gain on the sale of a 359,000 dollars oil payment for 154,000 dollars. Both the Board and the Court of Appeals characterized the interest sold as a sale of oil in place. Such a "property" anaysis would not seem capable of surviving *Lake*. There was, however, a risk factor because of the highly speculative nature of the interest sold. Since *Lake*, the Fifth Circuit in *United States v. Foster*[125] has stated that this factor must be taken into consideration and capital gains will result on the sale of a carved-out oil payment if the pay out of the oil payment cannot be predicted with reasonable accuracy.[126] Indeed, the Court was very critical of the position taken by the Commissioner, some courts, and legal writers which applies the "carve-out" rule in its most literal sense.[127] The Court then went on to find that the pay out of the oil payment could have been predicted with reasonable accuracy and, therefore, called for ordinary income treatment.

While the taxpayer lost, the *Foster* reading of *Lake* considerably narrows its reach and is more pertinent to the policies of capital gains taxation than notions of "carve-out" and "future income." If the pay out of the oil payment is not reasonably certain then the payment is treated as extending over the entire life of the interest from which it was carved, and is treated as a royalty interest.[128] This, of course, would be the sale of a "vertical slice," which clearly indicates the conversion of the investment in a fraction of the property, and capital gains treatment is called for. When *Lake* is viewed as involving the conversion of an investment risk, neither the "future income" nor the "carve-out" theory is necessary to a proper result and they are better discarded. Both theories suggest that retention of a reversion which consists of part of the property from which the assignment is made is fatal to capital gains treatment. Such a notion impedes proper analysis of a situation such as that in *Hort* where lessor's gain due to the value appreciation of the lease is separate and distinct

124. 37 B.T.A. 656 (1938).

125. 324 F.2d 702 (1963).

126. In the words of the Court:

> . . . the assignment of an oil payment (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, results in ordinary income if the pay-out of the oil payment can be predicted with reasonable accuracy at the time of the sale. Pay-out of an oil payment carved from producing property can be predicted with reasonable accuracy if it is not unreasonable to conclude that total reserves and the amount of production dedicated to pay-out are adequate for that purpose. For undeveloped property, however, an additional determination is necessary, i.e., that adequate pay-out production reasonably can be expected from the property.

Id. at 708.

127. No rule was established by *Lake* requiring *all* carved out interests to be taxed as ordinary income simply upon a finding that they were carved out and that the price received was not pledged for development. The substance and effect of the whole transaction must be examined; form alone will not control. Nevertheless, the Commissioner, some courts, and legal writers continue to espouse definitions and rules as to ordinary income or capital gain couched in terms of whether an interest is carved out or not.

Id. at 706.

128. United States v. Morgan, 321 F.2d 781 (1963).

from any value in the underlying realty. Also, it prevents capital gain treatment under the reasoning of *Foster*, where there is real "risk" involved in the sale and purchase of future profits. On the other hand, where no reversion is retained by a transferor and any investment held will necessarily have been converted, the "future income" theory may still be applied to prevent capital gain. There would appear to be no danger of this occurring where the asset sold is a "traditional" capital asset, such as stocks, bonds or real estate. However, the danger is a real one in the atypical case. An example is *Wilkinson v. United States*[129] which is worthy of discussion in some detail. Taxpayer, a lawyer, bought an interest in a contingent legal fee. The seller of the fee, a Captain Bonnin, although not a lawyer, in 1932 had been authorized by the Secretary of the Interior to represent certain of the Ute Indians in the prosecution of claims against the United States under a contract whereby Bonnin was to receive a fee of no more than 10 percent of any recovery. Apparently unable to provide the legal services himself, in 1935 Bonnin assigned the major portion of his interest in the contract to a firm of lawyers of which taxpayer was a member, and, in fact, taxpayer performed the legal services which eventually resulted in a recovery. Besides his interest in the contingent fee for which he was to perform services, in 1938 taxpayer purchased from Bonnin, and in 1950 from Bonnin's widow, a portion of Bonnin's reserved interest in the contingent fee. In 1951, after a judgment for almost 32 million dollars had been entered for the Ute Indians, but before the Court had fixed attorney fees, taxpayer sold for 73,000 dollars his interest in a portion of the fee which he had purchased for 16,000 dollars. In holding that the gain was ordinary income, the Court of Claims relied heavily on its decision in *Arnfeld v. United States*,[130] which had relied in part upon *Lake* to hold that gain on the sale of an annuity policy was a substitute for matured ordinary income and hence not capital gain. The proposition derived by the Court from *Arnfeld* was that in determining whether gain is a capital gain in the hands of the assignee, one must look at the nature of the income that would have resulted had there been no assignment. Since the fee would have been ordinary income to Bonnin had he collected it, reasoned the Court, the claim remained an ordinary income asset in the hands of Bonnin's assignee, the taxpayer, and a sale did not change the nature of the gain from ordinary income to capital gain. "Were we to hold otherwise," said the Court:

> we can visualize countless opportunities for individuals performing personal services to exploit this method of limiting their tax responsibilities. For example, two lawyers, each working on a contingent fee contract, might sell to the other the right to receive payment under their contract for a nominal sum. They would then aver that the gain realized was a capital gain because it represented gain on the sale or exchange of property.[131]

129. 157 Ct. Cl. 847, 304 F.2d 469 (1962).
130. 143 Ct. Cl. 277, 163 F. Supp. 865 (1958), *cert. denied*, 359 U.S. 943 (1959).
131. 157 Ct. Cl. at 857, 304 F.2d at 474.

The Court of Claims seems to have extended the "future income" rationale to the full extent of its logical possibilities. The position that the character of income cannot be changed by assignment would, of course, prevent capital gain treatment on the sale of stocks, bonds and real estate on the ground that the amount received representing future dividends, interest and rents must remain ordinary income. Nor can the rationale be sustained on the ground that a mere right to collect money which is not embodied in some traditional "property" such as stocks, bonds or real estate, is not a capital asset. The cases have explicitly recognized that such a right can be the subject of speculation and risk-taking and hence can be an investment asset.[132] Under these cases, and under any sensible view of what is an investment, the taxpayer in *Wilkinson* had made an investment. He bought his interests in the contingent fee for investment. Although the second interest was purchased in 1950, apparently just before the favorable decision when its value was less speculative than that of the interest purchased in 1938, as to both interests the amount of the recovery and fee were unknown. Taxpayer took the risk of gain or loss. The sale of his rights just prior to the time in 1951 when the fee was set was a conversion of an investment. Nor is the Court's example of two lawyers swapping fees persuasive. Besides being highly unrealistic, each fee received would seem to represent the value of the personal services rendered by the recipient to the other lawyer and would be treated as received for such services rather than for the nominal sum "invested." Hence, no capital asset would have been sold.[133] Also, the Court's reliance on the *Arnfeld* and on *Cotlow v. Commissioner*,[134] cases seems misplaced. These cases do not support the proposition that what would be ordinary income on receipt by the assignor remains ordinary income to the assignee. In *Cotlow* the purchaser of insurance renewal commissions was held to have ordinary income on receipt of commissions in excess of his cost but only because the *collection* of the commissions was not a sale or exchange, not because of the nature of the receipt in the hands of the assignor. Indeed, the Court made the point explicit that taxpayer had collected the commissions and had never sold

132. In Pacific Finance Corporation of California, 22 P-H Tax Ct. Mem. 391 (1953), taxpayer, a finance company, paid $450,000 for the right to receive the first $550,000 profits realized on the distribution of the motion picture "Rebecca." After receiving $375,000, it sold its interest in the profits of the film for $177,000. Refusing to apply the *Hort* rationale to these facts, and characterizing the asset as an "investment", *id.* at 396, the Tax Court held the gain was capital gain. In Ayrton Metal Co. v. Commissioner, 299 F.2d 741 (2d Cir. 1962), where taxpayer sold his interest in a joint venture which was engaged in the purchase and sale of ore from a particular mine, the interest being a right to share in the future profits of the venture, the Court held his gain was capital gain, expressly stating that the right to future, uncertain profits is a capital asset. *Id.* at 749. A like result obtained in Pat O'Brien, 25 T.C. 376 (1955) where there was a sale of a right to the profits from a motion picture. Also, the Commissioner has held that the sale of bond coupons acquired independently of the bonds produces capital gain. Rev. Rul. 54-251, 1954-2 Cum. Bull. 172. And the reasoning of United States v. Foster, 324 F.2d 702 (5th Cir. 1963), that the sale of a carved-out oil payment will result in capital gains if the payout of the oil payment cannot be predicted with reasonable accuracy recognizes the place of the risk factor in determining whether an investment has been sold.

133. See text accompanying notes 220-28 *infra.*

134. 228 F.2d 186 (2d Cir. 1955).

any of them. In *Arnfeld,* where the Court of Claims held that taxpayer's gain on the sale of an annuity policy was taxable as ordinary income, the result followed from the "accrued income"[135] doctrine under which payment received as a substitute for matured ordinary income in the nature of interest is not capital gain. *Arnfeld* did not involve the assignee's tax, but the result would be the same as in *Cotlow* on collection of the annuity because of the lack of a "sale or exchange."[136]

In *Wilkinson,* the literal application of the *Hort-Lake* "future income" theory brought about a most questionable result. Further evidence of the confusion caused by this rationale will be seen in two recent decisions of the Tax Court, which will be discussed in the next section in connection with the problem of "accrued income."

Original Issue Discount and "Accrued" Income

Recently, the Supreme Court had to deal with another stubborn problem in the capital asset definitional spectrum. In *United States v. Midland-Ross Corp.*[137] the Court was faced with the problem of whether gain on the sale of non-interest bearing promissory notes purchased at a discount was capital gain or ordinary income. Refusing to follow the long-standing authority of *Commissioner v. Caulkins*[138] that such gain was capital gain, the Court held that original issue discount was not gain representing appreciation in value, but simply ordinary income for the use or forbearance of money. The Court equated earned original issue discount with accrued stated interest.[139] The ordinary income

135. See text accompanying notes 137-49, *infra.*

136. *Wilkinson* may be viewed as involving the "accrued income" doctrine. On this point, compare, Doyle v. Commissioner, 147 F.2d 769 (4th Cir. 1945) involving not a sale but an assignment by gift by the taxpayer to his wife and children of a percentage of a breach of contract claim which had cost the assignor $928.75 and resulted in a payment of $34,926.01. In holding that the assignor remained taxable on the proceeds, the Court stressed the "ripeness" of the claim when it was assigned, the intra-family transfer and the assignor's practical retained control. This case at best is doubtful authority for the application of the "accrued income" rationale to assignment of an asset which, as in *Wilkinson,* had appreciated due to "risk" factors rather than buildup of ordinary income items such as interest. This distinction is clearly made in Friedman v. Commissioner, 346 F.2d 506 (6th Cir. 1965) where the assignor could not avoid the tax on payments representing the value of an endowment policy attributable to annual interest additions to the value of the policy. See also the discussion of the cases involving sale of accrued income items in the next section. Compare *Doyle,* with Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962).

137. 381 U.S. 54 (1965).

138. 144 F.2d 482 (6th Cir. 1944). Contrary to *Caulkins,* and in accord with the decision in *Midland Ross* are the following: Dixon v. United States, 381 U.S. 68 (1965); Real Estate Inv. Trust of America v. Commissioner, 334 F.2d 986 (1st Cir. 1964); Jaglom v. Commissioner, 303 F.2d 847 (2d Cir. 1962); United States v. Harrison, 304 F.2d 835 (5th Cir. 1962); Rosen v. United States, 288 F.2d 658 (3d Cir. 1961); Commissioner v. Morgan, 272 F.2d 936 (9th Cir. 1959); Fisher v. Commissioner, 209 F.2d 513 (6th Cir. 1954).

139. The $6 earned on a one-year note for $106 issued for $100 is precisely like the $6 earned on a one-year loan of $100 at 6% stated interest. The application of general principles would indicate, therefore, that earned original issue discount, like stated interest, should be taxed . . . as ordinary income.

381 U.S. 54, 58 (1965).

This problem no longer arises since Int. Rev. Code of 1954, section 1232(a)(2) provides, in substance, that any portion of the gain attributable to the original issue result was based upon the Court's usual canon of construction that the term "capital asset" must be construed narrowly so as to apply only to value appreciation accrued over a period of time, citing *Gillette Motor Transport* and *Corn Products*, and not to apply to property representing "income items or accretions to the value of a capital asset themselves properly attributable to income,"[140] citing *Hort* and *Lake*. However, in both *Hort* and *Lake*, the Court was concerned with the present realization of the value of future income. In *Midland-Ross*, there was involved quite a different facet of the problem which arises where items of income have "accrued" in the past and are realized by a sale of both the principle obligation and the accrued items. Unlike *Lake* and *Hort*, here there is no sale of "future income" and a retention of the "property" since the transferor has parted with his entire interest in the property. Because the taxpayer's investment has entirely ended, and any investment gain has been converted, the principles of *Hort*, *Lake*, and *Gillette Motor Transport* have no direct application. The question of termination of interest was not involved in *Midland-Ross* and the only question before the Court was whether taxpayer's gain was due to appreciation in value of his investment. The Court properly held that gain due to original issue discount is not gain due to appreciation. It is simply the amount earned by the investment up to the time of the sale and therefore is not a capital gain.[141]

The result in *Midland-Ross* reflects the basic position of most courts that where both the income producing asset and the right to accrued income from asset are sold together the purchase price must be allocated between the two and only the former is a capital asset.[142] In *Midland-Ross*, the Supreme Court specifically approved this view, stating that the amount received on sale or retirement of the discount note must be broken down into its component parts.[143] This principle has generally been applied to deny capital asset status to "matured" or "accrued" earnings of property.[144] Thus, on a sale of an interest in a partnership, a portion of the proceeds received for accrued partnership income is ordinary income;[145] where stock upon which a dividend has accrued is sold, that part of the purchase price allocable to the value of the dividend is ordinary income.[146] Likewise, in the case of sales of life insurance policies, endowment

discount will be treated as ordinary income. This provision does not apply to bonds or notes issued before January 1, 1955, such as the notes involved in *Midland Ross Corp.*

140. 381 U.S. at 57.

141. After saying this, unhappily, the Court again relied on its "future ordinary income" language from *Hort*. 381 U.S. at 58.

142. Jaglom v. Commissioner, 303 F.2d 847, 850 (2d Cir. 1962).

143. Citing Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945) and Watson v. Commissioner, 345 U.S. 544, 552 (1953).

144. See generally Lyon & Eustice, *supra* note 50, at 358-73, Jaglom v. Commissioner, 303 F.2d 847 (2d Cir. 1962).

145. United States v. Snow, 223 F.2d 103 (9th Cir. 1955), Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937), Tunnell v. United States, 259 F.2d 916 (3d Cir. 1958). These cases arose before the same result was required by specific provision in the Internal Revenue Code of 1954, §§ 741, 751.

146. Reg. § 1.61-9(c) (1957), Brundage v. United States, 275 F.2d 424 (7th Cir.

policies, and annuity contracts immediately prior to their maturity, courts have found that the portion of the selling price allocable to the accrued income will not receive capital gain treatment.[147] And amounts representing accrued motion picture rentals likewise are ordinary income.[148] In a slightly different context, involving the application of section 337, the sale by a cash basis corporation of fully performed contracts resulted in ordinary income.[149]

A problem similar to that of the sale of "accrued income" arises where property is sold for deferred payments and there is no allocation of the sale price for an interest element. This is so even though the longer the deferment, the greater the price the seller will demand because of the delay in payment. Congress has recently legislated to require an appropriate part of the deferred payments to be treated as interest both to the seller and the buyer as to sales or exchanges after June 1963.[150]

In a recent case the Tax Court seems to have carried the "accrued income" rationale too far. In *Donald B. Jones*[151] the taxpayer had purchased, as a speculative investment, a contingent trust remainder interest in a specific dollar amount. After the occurrence of the contingency and upon the vesting of the remainder interest the taxpayer sold his right to the specific dollar amount at a substantial gain. The gain was held to be ordinary income because had taxpayer merely collected the amount from the trustee he would have had ordinary income; also, this income had already accrued. The Tax Court relied upon *Jaglom v. Commissioner*,[152] which dealt with accrued bond interest, and upon the principle of *Lake* that the taxpayer had received a substitute for future ordinary income. This seems clearly to be an erroneous application of the "accrued income" doctrine. As the Supreme Court pointed out in *Midland-Ross*, earned original issue discount is simply compensation for the use or forbearance of money. "Unlike the typical case of capital appreciation, the earnings of discount to maturity is predictable and measurable, and is 'essentially a substitute for . . . payments which . . . must be regarded as ordinary income, . . .' "[153] In *Donald B. Jones*, however, the gain was in no way attributable to predictable and measurable earnings such as interest; on the contrary it represented appreciation of taxpayers investment in the remainder interest due to its ripening into a vested interest upon the death of the life tenant.

1960), *cert. denied*, 364 U.S. 831 (1961), discussed in Lyon & Eustice, *supra* note 123, at 366-69.

147. See discussion in Lyon & Eustice, *supra* note 50, at 369-71. The Tax Court now agrees with this result even as to endowment policies, which it had held in *Percy W. Phillips*, 30 T.C. 866 (1958), *rev'd*, 275 F.2d 33 (4th Cir. 1960), to give rise to capital gain. *Bolling Jones, Jr.*, 39 T.C. 404 (1962), *Abram Nesbitt*, 43 T.C. 629 No. 50 (1965). Compare the position taken in Comment, *supra* note 19, at 564-67.

148. Bessie Lasky, 22 T.C. 13 (1954).

149. Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962); Family Record Plan, Inc. v. Commissioner, 309 F.2d 208 (9th Cir. 1962).

150. Int. Rev. Code of 1954, § 483.

151. 40 T.C. 249 (1963).

152. Jaglom v. Commissioner, 303 F.2d 847 (2d Cir. 1962).

153. United States v. Midland-Ross Corp., 381 U.S. at 57.

On appeal, *Donald B. Jones* was reversed by the Third Circuit[154] and remanded to the Tax Court to allocate the purchase price between the value attributable to interest income and that attributable to the capital gain component—presumably appreciation. The Court of Appeals seemed to recognize that taxpayer's purchase discount involved the traditional type of discount which can give rise to capital gain—as in the case of gain received when a bond purchased at a depressed market price is redeemed at par.[155] But why any portion of the gain was allocable to interest income is puzzling. There would seem to be involved only "market discount" as distinguished from "original issue discount."

In *Donald B. Jones*, the Tax Court seems to have been overly influenced by both the "accrued income" cases and also the future income rationale of *Lake*. The *Lake* influence was also predominant in *Merchants Acceptance Co.*[156] where taxpayer sold at a gain certain notes receivable it had acquired at a discount. At the time of the sale, the discount and/or interest element was not yet earned or accruable.[157] The Tax Court nevertheless held, assuming the notes were not disqualified from capital asset status by section 1221(4), that the gain represented nothing more than the commutated value of taxpayer's right to earn future ordinary income in the form of interest. Thus, held the Court, under *Lake:*

> . . . the substance of what is sold is the right to receive future income, and the substance of what is received is the present value of that income which the recipient would otherwise obtain in the future. . . .[158]

As in *Wilkinson*, the *Lake* rationale has been carried to its logical extreme so as to convert into ordinary income the normal appreciation due to market factors in an admittedly capital asset. Such reasoning, by denying capital gain treatment to the receipt of future unearned income, would require ordinary income treatment in such traditionally capital gain transactions as sales of real estate, stock, and especially bonds.[159]

Sales of Life Estates

The capital asset definitional problem has arisen in one of its most graphic forms where there has been a sale by a life tenant of his life interest in prop-

154. Jones v. Commissioner, 330 F.2d 302 (3d Cir. 1964).
155. United States v. Harrison, 304 F.2d 835, 838 (5th Cir. 1962). "The gain realized from such a transaction is a form of capital appreciation that resembles the capital gain received when stock or real estate is purchased and later sold at a profit, in contrast to an original issue discount gain which represents the interest or compensation paid for the use of money loaned." The distinction is between "market discount" and "original issue discount." For examples and discussion of this distinction, see Lubin v. Commissioner, 335 F.2d 209 (2d Cir. 1964); Rev. Rul. 60-210, 1960-1 Cum. Bull. 38; and Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case*, 20 Tax L. Rev. 1, 20 (1964).
156. 23 CCH Tax Ct. Mem. 896 (1964).
157. This fact is not too clear from the opinion. The court quotes from the Commissioner's pleading which stated that the gain consisted exclusively of "unamortized discount (deferred income)." 23 CCH Tax Ct. Mem. at 897-98. See Eustice, *supra* note 155, at 21.
158. 23 CCH Tax Ct. Mem. at 899.
159. See Eustice *supra* note 155, at 22.

erty.[160] Take for example the owner of a fee in rental real estate who deeds the remainder, reserving a life interest. Later he sells the life estate to the remainderman. Is the receipt a return of capital with any gain being capital gain, or is it ordinary income? Is capital treatment prevented by lack of a "sale or exchange?" If gain is capital, is the seller entitled to have any part of the overall basis of the property allocated to the life estate? If so, how is that basis to be determined? Is the remainderman entitled to amortize the cost of the life estate over the life expectancy of the seller?

The courts have held that such a sale by a life tenant is a sale of a capital asset and that the life tenant is entitled to a basis in the life estate.[161] In *Bell's Estate v. Commissioner*[162] where a court of appeals was first faced with the question, the Court had to decide between two competing lines of authority. *Blair,* which held that a life interest in property was "property" the assignment of which shifted the tax to the assignee, was a logical candidate to control the result. The Commissioner however urged that *Hort* should control because the consideration received by the life beneficiaries was no more than an advance payment of future income. Despite the fact that *Blair* did not involve a sale, and although *Hort* did, it was held that *Blair* controlled; that an interest in property for assignment of income purposes was likewise such an interest for capital gains purposes. *Hort,* said the Court, involved merely "naked rights to receive income"[163] and not an interest in property. An identical result obtained in *McAllister v. Commissioner*[164] where the Court also rejected the Commissioner's position that there had been no sale or exchange because the seller had "surrendered" her rights rather than assigned them. Severely criticizing the distinction made between a sale on one hand and termination, cancellation, or surrender on the other, the Court held that a surrender to the remainderman had the same effect as a transfer to third persons, stressing that in both situations the transaction is of an "essentially dispositive nature."[165]

Since the life tenant has been held to have sold a capital asset, the Court decisions have allowed him a basis in the life interest. However, under these decisions, the method of computing the basis is ambiguous.[166] Strangely enough, here it is the Commissioner who has come to the aid of the taxpayer by providing in his Regulations that upon sale of a life estate there is allocated to it a portion

160. See generally, Lyon & Eustice, *supra* note 123, at 321-27; Plumb, *Tax Effects of Sales of Life Interests in Trusts, How To Eat Your Cake And Have It,* 9 Tax L. Rev. 39 (1953).

161. McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied,* 330 U.S. 826 (1947); Allen v. First Nat'l Bank & Trust Co. in Macon, 157 F.2d 592 (5th Cir. 1946); Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943); Estate of Robert J. Cuddihy, 32 T.C. 1171 (1959); Gladys Cheesman Evans, 30 T.C. 798 (1958), *acq.,* 1958-2 Cum. Bull. 5; Sayers F. Harman, 4 T.C. 335 (1944); Estate of Joseph N. Camden, 47 B.T.A. 926 (1942), *aff'd per curiam,* 139 F.2d 697 (6th Cir. 1943).

162. 137 F.2d 454 (8th Cir. 1943).

163. *Id.* at 458.

164. 157 F.2d 235 (2d Cir. 1946), *cert. denied,* 330 U.S. 826 (1947).

165. *Id.* at 237.

166. See discussion in Lyon & Eustice, *supra* note 123, at 322-23.

of the overall basis in the property assignable to the life interest under a table of factors based upon actuarial principles.[167] The entire property has a "uniform basis" with the life estate and remainder interest having sub-bases which continually shift in relation to each other, the basis in the life estate constantly decreasing and that in the remainder constantly increasing. At the death of the life tenant, the remainderman would have the whole of the uniform basis. Thus, a life beneficiary of property having an overall basis of 100,000 dollars at 40 years of age could sell the life interest for 62,908 dollars[168] and have no gain or loss.

Moreover the remainderman will be entitled to amortize the cost of the purchased life estate over the life expectancy of the life beneficiary.[169] Nor does it appear, although there is absence of specific authority on the issue, that upon the death of the life tenant, the remainderman's basis in the entire fee would be reduced for the portion of the overall basis already used by the life tenant on the sale.[170] Since the remainderman is generally entitled to the full adjusted uniform basis at the life tenant's death, he should not be penalized for a use of part of it by the life tenant on a sale of the life estate. Of course, this question should not be affected by his ability to amortize the cost to him of the life estate since he has a "cost" basis in that asset, which is separately acquired from the remainder interest.

It seems strange indeed that the lessor in *Hort* who, under the analysis of that case sells "future rentals" of real property, receives ordinary income, while the life tenant of rental real property, whose rights consist essentially only of the right to future rentals therefrom,[171] sells "property" and receives capital gain. And the life tenant's bounty is twice blessed: since gain is capital, apparently it inexorably follows (even the Commissioner admits it in his Regulations) that the life estate must be assigned part of the overall basis of the property. This is so even though the life tenant is generally treated under the Code as being simply in the income shoes of the remainderman, being unable to recover any basis by amortization against the annual income payments[172] and not being given the exempt income benefits accorded to property received by gift, bequest, devise or inheritance.[173]

To make the comparison of the life estate cases with *Hort* more striking, assume that the term of the leasehold in *Hort* was exactly the same as the life expectancy of the life tenant in the life estate case, or even longer. Can any rational argument be made that a sale of the future rentals in each case should

167. Treas. Reg. § 1.1014-5(a) (1957); Treas. Reg. § 1.1015-1(b) (1957).
168. Treas. Reg. § 1.1014-5(a) (1957).
169. Bell v. Harrison, 212 F.2d 253 (7th Cir. 1954).
170. See Treas. Reg. § 1.1014-4(a) (1957). The ramifications of the problem are discussed in Lyon & Eustice, *supra* note 123, at 323, n.126.
171. See text accompanying notes 54-56 *supra*.
172. Int. Rev. Code of 1954, § 273, disallows amortization of a life estate acquired by gift, bequest or inheritance.
173. Int. Rev. Code of 1954, § 102(b).

be treated differently? The stress of *Blair*, that the life tenant owns an equitable interest in property, is hardly a reason for denying capital gain treatment to a lessor who owns the entire fee—both a legal and equitable interest—in his property. But apparently it can make a difference that the estates are separated, with a life estate receiving favorable treatment even though it is sold by one who continues to own the reversion. In *Estate of Johnson N. Camden*,[174] the taxpayer carved a life estate out of her fee and sold it to her husband. Rejecting the Commissioner's theory that the life estate should be treated as a lease and the consideration received by the taxpayer as prepaid rent, the Court found that a life estate had been sold and that this was the sale of a capital asset. *Hort* was distinguished on the ground that there was involved "merely . . . the cancellation of a lease."[175] Of course, it is difficult to predict whether this case will survive *Lake* because of the factor of carve-out.

The "property" approach of *Blair* is the obvious factor which leads to the difference in result in the above example. The result is clearly unjust, if only because under the rationale of *Hort* the life estate cases should also have given rise to ordinary income. The injustice is compounded when it is realized that each of the cases, *Hort* and the life estate case, would be more justly decided if their results were reversed: capital gain in *Hort* due to the value appreciation in the lessee's promise to pay rent, and ordinary income in the life estate cases where no value appreciation is being converted separate from that in the underlying fee. There is no reason to treat the sale of a life estate any differently than a "sale" of a lease to a lessee for a lump sum. Unlike the situation in *Hort* where the lease was terminated and the investment therein converted at a gain representing a value independent of the underlying real estate, the seller of a life estate sells no commitment independent of and separate from the income-producing corpus.[176]

To make matters even more snarled, the selling life tenant is given a basis for purposes of sale which basis can only be a part of the overall basis of the property (except in the case where the life estate is purchased separately), while in *Hort*, a basis for the lease was denied.[177]

174. 47 B.T.A. 926 (1942), *aff'd per curiam*, 139 F.2d 697 (6th Cir. 1943).

175. *Id.* at 931.

176. If a lease favorable to the lessor is present, part of the gain would be due to appreciation of the value of the lease, as in *Hort*.

177. 313 U.S. at 32. *Hort* is often accepted for the proposition that no separate basis is assignable to the premium value of a favorable lease, *i.e.*, the difference between the rentals provided in the lease and the fair rental of the property at the time the property is acquired by inheritance or by purchase. This interpretation is possible from the language of the Court seeming to deny to the real estate and the lease separate values upon inheritance, even though this was "theoretically" possible. *Ibid.* However, there appeared to be no evidence that in 1928, at the time of the inheritance, the value of the real estate had been enhanced by the lease and so no separate basis in the lease was acquired. Taxpayer seemed to be trying to establish a loss by reference to the value of the lease at the time of the cancellation, in 1933, and that value was irrelevant to any basis. In fact, the Tax Court expressly found that the lease had no value in 1928. Walter M. Hort, 39 B.T.A. 922, 925, 926 (1939). This interpretation is confirmed by the Supreme Court citation of Appeal of Farmer, 1 B.T.A. 711 (1925), 313 U.S. at 32, a case which denied a separate basis to a lease

The combined effect of the rules governing the sale of life estates is startling. Most striking is the possibility of complete avoidance of income tax during the life of the selling life tenant. Take the example of a life beneficiary of a trust holding securities worth 100,000 dollars at the time the estate is inherited.[178] More than six months later, at age forty, the beneficiary sells the life estate to the remainderman for 62,908 dollars. Since this is the portion of the uniform basis allocable to the life estate[179] the life tenant has no gain or loss and the sales price is received completely free of tax. Nor does the remainderman pay any tax as he receives the yearly income, except to the extent that the annual income exceeds his amortization deduction. In fact, if the remainderman does not wish to make a lump sum purchase, he may agree to pay fixed annual payments to the beneficiary for life. Then he may use the annual trust income to pay the purchase price. This was the technique used in *Gladys Cheesman Evans*[180] where the buyer of the life estate reported as income from the trust only the amount in excess of his installment payment to the seller. The seller was held not to have to pay tax on her receipts until her basis was recovered, and then any gain was capital gain.[181]

In *Evans*, the Tax Court rejected the Commissioner's contention that there was no sale, the Commissioner arguing that the taxpayer had merely exchanged the life estate for an annuity paying amounts she could just as well have received as a life tenant, so that there was no change effected in her economic position. This argument smacks of an objection to the "boot strap financing" technique whereby the purchase price of property is paid with future earnings from the interest purchased.[182] The Tax Court distinguished *Evans* on this point in *May*

made after the property was acquired. Thus it appears that a basis for the lease was correctly denied in *Hort* and that the question of allocation of a separate basis for the purchase or inherited premium value of a favorable lease was not decided. See Rubin, *Depreciation of Property Purchased Subject to a Lease*, 65 Harv. L. Rev. 1134, 1142, n.28 (1952); Chirelstein, *supra* note 47, at 30-31.

The basis issue, of course, in no way affects the question of whether the receipt by the lessor upon cancellation of a lease after rentals decline in the market is capital gain or ordinary income. The fact that there is a zero basis in the lease in no way prevents it from appreciating due to such a decline, and thus having a value separate from the real estate.

For cases concerning the question of assignment of a separate basis to a lease where one owns both the real property leased and the lease itself, and the lease and property are acquired when the lease has a "premium value" see Millinery Center Bldg. Corp. v. Commissioner, 350 U.S. 456 (1956); World Publishing Co. v. Commissioner, 299 F.2d 614 (8th Cir. 1962); Schubert v. Commissioner, 286 F.2d 573 (4th Cir. 1961); Bernstein v. Commissioner, 230 F.2d 603 (2d Cir. 1956); Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 347 U.S. 942 (1954); Friend v. Commissioner, 119 F.2d 959 (7th Cir. 1941), *cert. denied*, 314 U.S. 673 (1941); Peters, 4 T.C. 1236 (1945). *Cf.* Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805 (6th Cir. 1948); Young v. Commissioner, 59 F.2d 691 (9th Cir. 1932). See generally, Rubin, *Depreciation of Property Purchased Subject to a Lease*, 65 Harv. L. Rev. 1134 (1952).

178. The trust property would have a basis of $100,000 under Int. Rev. Code of 1954, § 1014.

179. Treas. Reg. § 1.1014-5(a) (1957).

180. 30 T.C. 798 (1958) *acq.*, 1958-2 Cum. Bull. 5.

181. See discussion of the Evans case in Lyon & Eustice, *supra* note 50, at 323-25.

182. See authorities in Lyon & Eustice, *supra* note 50, at 325, n.132.

T. Hrobon[183] where taxpayer transferred to her husband a life estate in trust. In consideration of the transfer, the husband agreed to pay her 60 percent of the net annual distributions of the trust. Holding that the amounts received by the seller were taxable as ordinary income, the Court found that there had been no sale of the life estate but simply a transfer to her second husband by gift of the right to receive 40 percent of the distributions of the trust, with the seller in effect reserving 60 percent of those distributions to herself. Therefore, *Bell's Estate* and *McAllister*, where the transfers were for a lump sum consideration, did not apply. Nor did *Evans*, where the transferor was to receive annual payments in fixed amounts regardless of the income of the trust. In *Hrobon*, unlike those cases, the compensation to be paid was dependent upon, or determined as a percentage of, the trust income and therefore there was no sale of the interest.[184] The United States Supreme Court recently passed on this point in *Commissioner v. Brown*.[185] There a charitable foundation purchased shares of stock of a corporation for 1.3 million dollars, the purchase price in effect to be paid out of 72 percent of the operating profits of the business with no obligation on the part of the buyer to make any payments except from the profits. The Commissioner argued that there had been no substantial change in the economic position of the seller since there had been no shift of business risk. The Court, reviewing the cases dealing with retained economic interest, rejected this position, to make it clear that:

> To require a sale for tax purposes to be to a financially responsible buyer who undertakes to pay the purchase price from sources other than the earnings of the assets sold or to make a substantial down payment seems to us at odds with commercial practice and common understanding of what constitutes a sale.[186]

Of course, *Hrobon* can be distinguished from *Brown* since in *Hrobon* the life estate was not sold for a fixed price and thus there was no ceiling on the buyer's liability and no point at which the seller's interest in the asset sold would end.

Although the holding of the Tax Court in *Hrobon* seems to be that there had been no sale of the life estate, there is some language in the opinion to the effect that the whole area is subject to re-examination because of the decision of the Supreme Court in *Lake*. The Court notes that the cases allowing capital gains on such sales[187] were decided prior to *Lake*.[188] Then, after holding there had been no sale of the life estate, the Court continued that even if there had been a "transfer,"[189] the principles of *Lake* and *Gillette Motor Transport Co.* require a holding against the taxpayer. However, further discussion indicates

183. 41 T.C. 476 (1964).
184. *Id.* at 497.
185. 380 U.S. 563 (1965).
186. *Id.* at 575. See generally, Zarky, *supra* note 69, at 399-402; Surrey, *supra* note 18, at 1219-1220.
187. McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946); Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943); Gladys Cheesman Evans, 30 T.C. 798 (1958).
188. 41 T.C. at 493.
189. *Id.* at 497.

that these cases are being applied with regard to the "sale or exchange" requirement rather than that of "property."[190] Nevertheless, the language of *Hrobon* shows discontent with the rule of *Bell's Estate* and *McAllister*. It may be the first warning of a brewing storm that will eliminate the influence of *Blair* in this area. Since one mistake often cancels out another, no one should be surprised if the *Hort-Lake* future income rationale finally prevails.

Employment Contracts, Exclusive Agency, Distributorship and Other Contract Rights

The commercial transactions involved in exclusive agency and management contracts, distributorship agreements, "requirements" and "output" contracts, exclusive licenses, and commitments made to supply goods or services are perhaps the most productive source of litigation on the question of what is "property." The contracts, involving a blend of physical property, personal services, good will, and appreciation in value of commitments made, are not the traditional form of asset accorded capital treatment. Also, since the contractual rights involved are not freely marketable, dispositions are most generally by way of termination or cancellation of rights, raising the issue of "sale or exchange."

One of the main ingredients in the complex asset generally termed an "agency contract" is the factor of personal services. Therefore, before discussing these contracts in general, discussion will focus first on the employment contract.

A. Contracts for the Performance of Personal Services

It is abundantly clear that Congress did not intend the preferential capital gain treatment for compensation received in payment for the performance of personal services. This conclusion follows both from the legislative history[191] and specific statutory provisions, although Congress has not been entirely consistent in this area.[192] Section 1221 denies capital gain treatment to a copyright, literary, musical or artistic composition sold by the creator thereof.[193] Also excluded from capital gain treatment are accounts or notes receivable acquired in the ordinary course of business for services rendered.[194] Also, on the sale of

190. We think that applying the doctrine of the above two Supreme Court cases to the transaction here involved requires us to hold that the income received by May during the years here involved is taxable as ordinary income rather than capital gain. True, we find that there was a transfer of May's equitable interest in the trust corpus but we can find no conversion of that interest for cash insofar as May was concerned. All she was receiving after the transaction was a part of the same income she was receiving prior to the transaction. . . . May was simply receiving a lesser amount of the distribution from the trust than she had previously received and there was no sale or exchange of that right.

Id. at 498.

191. See text accompanying notes 29, 30, *supra*.

192. Receiving the favored treatment are inventors, Int. Rev. Code of 1954, § 1235, and pension plan beneficiaries receiving termination distributions, Int. Rev. Code of 1954, §§ 402(2), 403(a)(2). See also Int. Rev. Code of 1954, §§ 421-25, relating to restrictive stock options, preferred tax treatment thereof having been substantially tempered by the Revenue Act of 1964.

193. Int. Rev. Code of 1954, § 1221(3).

194. Int. Rev. Code of 1954, § 1221(4).

an interest in a partnership, the capital gain treatment generally allowed[195] is denied to receipts allocable to rights to payment for "services rendered, or to be rendered."[196] There is a similar rule applicable on sales of stock of or distributions from collapsible corporations.[197] Further evidence is the inclusion in "personal holding company income" of income from "personal service contracts."[198]

Clearly then wages, salaries, and fees which are received in the normal course or when sold as receivables by the earner thereof in return for a lump sum payment are not entitled to capital gain treatment.[199] However, neither the legislative history nor any section of the Internal Revenue Code seems to reach a situation where an employee receives a payment in cancellation of, or upon the sale of, an employment contract.[200] The result in such situations is controlled solely by decisions of the courts.[201]

As already indicated, where the question presented has been whether a claim for compensation for services rendered in the past is entitled to capital gain upon sale, the courts have uniformly held that the receipt is ordinary income.[202] The reasoning of the courts is well illustrated by *Hubert M. Luna*[203] where taxpayer received a lump sum payment from an insurance company in settlement of his right to receive renewal commissions upon insurance policies issued prior to the termination of his employment with the company. Predictably, the court held the receipt was ordinary income relying on the *Lake* "future ordinary income" rationale,[204] and also holding there had been no sale because of the failure of the rights transferred to survive the settlement.[205] Although the court's reasoning can be criticized because it is founded upon the inept future ordinary income rationale of *Lake*, and the much criticized doctrine denying "sale or exchange" status to a cancellation, the result is proper. Amounts received for personal services already rendered are within the congressional intent

195. Int. Rev. Code of 1954, § 741.
196. Int. Rev. Code of 1954, § 751(a), (c).
197. Int. Rev. Code of 1954, § 341(b)(4).
198. Int. Rev. Code of 1954, § 543(a)(7).
199. See generally, Miller, *Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code*, 64 Yale L.J. 1, 16 (1954).
200. *Ibid.*
201. There will be no discussion of cases where the issue was one of fact; *i.e.*, whether the payment was compensation for personal services or the purchase price of a capital asset the value of which is not easily ascertainable, such as a screenplay sold by a performer in the film (Fred MacMurray, 21 T.C. 15 (1953)), stock of a corporation under contract to produce a radio show starring the owner of the corporate stock (Jack Benny, 25 T.C. 197 (1955)), the partnership interests of partners who formed the partnership to produce a radio show (Julius H. Groucho Marx, 29 T.C. 88 (1957)). The issue in these cases was whether the amount was paid for the asset allegedly sold or for the services of the individual taxpayer. See also cases in Miller, *supra* note 199, at 1 n.2, Mertens, *Law of Federal Income Taxation*, § 22.32.
202. Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962); Hubert M. Luna, 42 T.C. 1067 (1964); Glen E. Alexander, 34 T.C. 758 (1960); Gerald B. O'Neill, 23 T.C.M. 7 (1964).
203. 42 T.C. 1067 (1964).
204. ". . . the taxpayer's rights—despite in their totalitarity they may be deemed 'property'—represent only the taxpayer's claim to amounts which would be ordinary income to him as received. See *Commissioner v. P. G. Lake, Inc. . . .*" *Id.* at 1079.
205. *Id.* at 1079.

not to allow capital gains for the ordinary recurring receipts from the fruits of property or labor, although received in a lump sum.[206] Similar to the cases decided under the "accrued income" theory where the gain is derived from past earnings of property, in this situation the gain is attributable to past earnings from personal services. There is no element of gain due to appreciation in value.

More difficult is the case of an employee who receives a lump sum payment upon the cancellation of a contract to perform personal services, or sells the contract to another, the consideration in no way representing payment for past services. Here also, where the contract is only for the performance of personal services as distinguished from exclusive agency or distributorship contracts where generally some capital investment or goodwill is also present, the courts have unanimously held against the taxpayer.[207] In *Thurlow E. McFall*,[208] McFall contracted to work for five years as superintendent of Sparta Foundry Co. for 100 dollars per week and a percentage of profits. Two years later he sold his contract rights to A. W. Clutter & Co. which had obtained a release of the rights from Sparta. McFall received 175,000 dollars for his rights to perform future services under the contract. The Board decided that the receipt was ordinary income, relying on two main ideas. First, McFall had nothing he could sell. The right to work in the future and be paid therefore could not be sold before performance, and after performance the right was exhausted. Therefore, reasoned the Board, there was nothing McFall could "own" for any period of time. The right is "property" in the constitutional sense but it is not capital. "Obviously it is not the sort of property which is susceptible of ownership for a length of time as is a share of stock, a bond or a thing."[209] The second ground of the decision appears to be that the statute "is not served by including within it the contractual expectation of receiving pay for services not yet performed . . . ."[210] No congressional authority was cited as to the purpose of the statute.

Interestingly enough, the Board refused to decide the case upon the Commissioner's argument that McFall was receiving in advance the pay he would have received had he continued to perform services under the contract and for that reason the payment was ordinary income. After *Lake*, however, this argument of the Commissioner was not to be denied. In *Holt v. Commissioner*,[211] taxpayer, a motion picture producer, entered into a contract with Paramount Pictures whereby he was to produce a number of motion pictures in return for a stated salary together with a share of gross receipts. After a few years, the contract was cancelled because of a decline of public interest in the type of pic-

206. See text accompanying notes 29, 30, *supra*.
207. Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962); Victor H. Heyn, 39 T.C. 719 (1963); David L. Gordon, 29 T.C. 510 (1957), *aff'd*, 262 F.2d 413 (5th Cir. 1958); Rev. Rul. 58-301, 1958-1 Cum. Bull. 23; F. W. Jessop, 16 T.C. 491 (1951); Herman Shumlin, 16 T.C. 401 (1951); George K. Gann, 41 B.T.A. 388 (1940); Thurlow E. McFall, 34 B.T.A. 108 (1936); F. R. Ingram, 20 CCH Tax Ct. Mem. 1447 (1961).
208. 34 B.T.A. 108 (1936).
209. *Id.* at 110.
210. *Id.* at 110-11.
211. 303 F.2d 687 (9th Cir. 1962).

ture being produced and taxpayer was paid a lump sum upon the cancellation. Relying upon *Lake, Horst* and especially upon *Hort,* the Court found that taxpayer had received merely a substitute for future ordinary income and was not entitled to capital gains treatment. The payment to the taxpayer was treated as if it had been received as compensation for his services as a producer.[212] The settlement appears to have been both for past services and for release of the obligation to pay for future services. The Tax Court had found that the compensation was for services "rendered or to be rendered,"[213] and *Holt* has been so interpreted.[214] But the Court made no distinction along these lines and the entire payment to taxpayer was thought to be controlled by the *Lake-Hort* rationale.

McFall and *Holt* reveal three distinct grounds for denying "property" status to a long-term contract to perform personal services. Under *McFall,* it is an asset which is not capable of ownership; also it was not intended by Congress to have preferred treatment. Under *Holt,* the payment in cancellation of the contract is treated the same as income earned under the *Hort-Lake* "future income" approach.

All three of these grounds are subject to criticism. In *McFall,* the taxpayer did own something which was capable of ownership before services were performed: a commitment of his employer in the form of a promise to pay money on the providing of services. The Board states that this right of payment on the performance of services is not the same as a stock, bond or thing. This statement reflects more a habit of thought regarding the nature of capital assets than it does a reasoned approach. The owner of a bond owns only the right to periodic payments in return for supplying money. He owns a commitment in the form of a promise that there will be paid to him a certain amount of money in the future. McFall owned exactly the same kind of commitment, although the consideration for it was his return promise to perform personal services instead of an investment of money. Such a promise is capable of ownership, and most important, is capable of appreciation when the market rate of labor declines, the same as is the promise in the bond when there is a decline in the general market rate of interest. Therefore, capital gain for that appreciation upon its sale could not be denied on the ground that McFall owned no property he could sell.

The "future income" doctrine applied in *Holt,* which treats amounts received by the employee on cancellation of a contract to perform personal services as payment for performance of those services, is subject to a like criticism. As in *Hort,* where the lessor was not being paid for supplying the premises, in *Holt* and in *McFall* a payment in cancellation of a contract to perform services in the future is not a payment for services. Upon the cancellation the employee is no longer required to perform services. As is clear from the facts in *Holt* where

212. *Id.* at 691.
213. *Id.* at 689; 35 T.C. at 597, 598.
214. Commissioner v. Ferrer, 304 F.2d 125, 130 (2d Cir. 1962).

public interest declined in the type of picture taxpayer was to produce, the payment on cancellation is received on account of the appreciation to the employee of the employer's long-term commitment to pay a stated amount for services, which appreciation is due to a decline in value of the services to be performed. The situation is again analogous to that of a bondholder when there is a decline in the value of money with a corresponding drop in the market rate of interest. The resulting gain on a sale of the bond is due to appreciation of the obligor's commitment to pay a fixed interest, the appreciation being due to the general decline in interest rates. Both situations involve the realization of appreciation in value within the language of the Supreme Court in *Gillette Motor Transport, Inc.*[215] The bondholder is not treated as if he had received "future income" over the life of the bond; nor should the employee be treated as if he had been paid for personal services performed over the life of the contract.[216]

The second ground relied upon in *McFall*, that "the purpose of the statute, whether it be liberal or strict, is not served by including within it the contractual expectation of receiving pay for services not yet performed,"[217] is also open to question. Neither the legislative history of section 1221 nor any provisions of the Internal Revenue Code are pertinent to the situation in *McFall* since they all indicate an intent that recurring receipts for personal services, whether received in the normal course or in a lump sum after they have been earned, be taxed as ordinary income. Thus, salary, rents, dividends and interest do not receive capital gains treatment. However, as already seen, the gain in *McFall* was not for the performance of personal services but due to the appreciation in value of a commitment to pay a stated amount for services. Once this fact is recognized, it seems clear that in the *McFall* situation both the employer and the employee made an "investment"; each bound himself to an exchange of money and services at a stated price for a substantial period of time. Thus, each of the parties assumed a market risk: the employee that the price of his labor would remain stable or increase; the employer that this price would remain stable or decrease. A change in the value of the employee's labor will cause each of them to sustain a profit or loss upon the cancellation or sale of the contract. Since it was the intent of Congress to provide inducement for "risk-taking," it is not at all clear that a long-term personal services contract is not within that intent.

Not only is there present "risk-taking" but the commitment by McFall of his personal services on a long-term basis at a fixed compensation would seem as valuable an "investment" as a commitment of money capital. In certain situa-

215. 364 U.S. 130 (1960).

216. The transaction is characterized by Chirelstein, *supra* note 47, at 29, "as involving a sale of an opportunity to profit rather than a compensated service . . ." which presents ". . . an instance of accrued value appreciation . . . a broad test of . . . [which] would be whether the taxpayer possesses an interest which can be disposed of for a consideration without the further commitment of his own resources, that is, without obligation on the taxpayer's part to perform a further service or to furnish anything additional in the way of labor or capital. . . . The source of value . . . is in the contract commitment itself and in the willingness of the parties to take the risks of the market for the period agreed upon."

217. 34 B.T.A. at 110-11.

tions, and *McFall* and *Holt* seem typical of them, an employer will not commit himself to a business or venture unless he is assured of the availability of certain skills or services for a long term. Therefore, as much as money capital, a long-term employment contract will contribute to what "investment" and "capital mobility" are dedicated: the creation of new jobs and economic growth.[218]

On the other hand, in *Holt* it was suggested that a capital transaction require a capital investment and that the taxpayer was not entitled to capital gains since he had invested nothing except his services as a producer.[219] *Holt* is not strong authority for such a position since the Court relied mainly on the future ordinary income rationale and further, the payment received was at least in some part and perhaps in large part, considered to be for past personal services. However, in *Ralph Bellamy*[220] the Tax Court placed strong reliance on this factor. Taxpayer, a prominent actor, had made a series of television films under a contract which prevented the films from being re-run on the expiration of a specified time after the expiration of the contract. The right not to have the films re-run after this time was important to Bellamy in order to prevent the films from competing with his current acting commitments and also because they might prove detrimental to his professional career by "typing" him with the detective he played in the films, a "Mike Barnett." Eight years later, while Bellamy was acting in a Broadway play, and feeling it would be helpful to have some television exposure during this time, in return for a lump sum payment of 89,000 dollars he released his right to prevent the re-runs so that the films could again be shown. Relying heavily upon the language in *Gillette Motor Transport*[221] to the effect that the right to use one's property is not something in which there is any investment separate and apart from the physical property itself and that no basis could be allocated to such right to use, the Tax Court held that Bellamy had no investment in the right to prevent re-runs. Hence, reasoned the Court, that right had no basis in his hands, and therefore it was not a capital asset. Such an analysis seems improper. First, *Gillette Motor Transport* is misapplied. There the Supreme Court was dealing with a receipt in the nature of rent where only the use of the property and not the physical asset itself had been sold. The language of the Court relied upon in *Bellamy*[222] was used by the Court to accentuate the fact that the right to *use* of physical property is not the property in which there is the investment. Its language regarding basis is not necessary to this proposition and seems to do no more than point up the fact that the right

218. In this context, the point is often made that labor needs no incentive since the working man has no alternative but to work. He cannot keep his labor off the market without losing his income entirely, whereas the holder of a stock or bond has the alternative of enjoying a recurrent yield instead of transferring the asset. Comment, *supra* note 27, at 742. *But see* Miller, *supra* note 25, at 1076. This argument certainly has validity as regards the ordinary salary of the working man. However, it fails to reach the *McFall* situation since there the contract was an alternative that could be induced. McFall could have stayed on the normal market instead of tying up his services for five years.

219. 303 F.2d 687, 691 (9th Cir. 1962).

220. 43 T.C. 487 (1965).

221. 364 U.S. 130 (1960).

222. 364 U.S. at 135.

to use ordinarily can have no basis separate from the basis of the physical property.[223] To construe the Court's statement to mean that property which has a zero basis due to lack of capital investment cannot be a capital asset is unwarranted. There is no better example of a person who has solely a right to use in which he has a zero basis due to lack of investment than a lessee. A literal application of the holding in *Bellamy* would turn into ordinary income the gain of a lessee on the cancellation of a lease he has not purchased.[224]

In section 1241 of the Code, Congress has also hinted at a requirement of substantial capital investment where it guarantees "sale or exchange" treatment for cancellation of leases or "a distributor's agreement (if the distributor has a substantial capital investment in the distributorship)." The Senate Finance Committee Report expressly states that this section is not intended to deal with the requirement of the presence of a "capital asset."[225] If this is so, it is difficult to see why the statute contains the parenthetical clause requiring a "substantial capital investment" in a distributorship before sale or exchange consequences will follow. In withholding sale or exchange treatment for cancellations of distributorships where there is no such investment, the Congress seems to be making a decision that such distributorships are not capital assets. However, this inference is contradicted by the fact that no such requirement of investment is imposed for a lessee to have the benefit of the section, even though a lessee will have no investment in the lease. Nor did *Bellamy* rely on this section for its conclusion regarding the need for investment. Apparently the Committee Report's express denial of an intent to define "capital asset" is to be taken at face value.

It would therefore appear that the opinion of the Tax Court in *Bellamy* regarding the necessity of investment cannot be read broadly, but must be read in connection with the personal services required by Bellamy under the contract. Thus viewed, it is seen that Bellamy's right to prevent re-runs was received in consideration of his performance of personal services under the contract. The amount received on sale of those rights therefore represented payment for past personal services and must be taxed as ordinary income. Unlike *McFall* where the amount paid to the taxpayer on the sale of a personal service contract was

223. Of course, if the property is purchased or inherited in such form as a lease with "premium value" then it is possible to have a separate basis therein. See note 178, *supra*.

224. In A.L.I. Draft, *Definitional Problems in Capital Gains Taxation* (1960) the position is taken that in order for property to be a capital asset it must represent a substantial capital investment. "If the inherent nature of the asset is such that its acquisition does not characteristically involve an outlay of funds or commitment of credit, the according of capital gain treatment on its subsequent disposition cannot be justified on the ground of encouraging risk taking. The . . . Draft . . . therefore provides as a requirement of capital asset classification that the asset be of a class which characteristically requires either an outlay of funds or commitment of credit at the time of its acquisition." Pp. 10, 11. This position fails to take into account that other commitments besides those of capital or credit involve risk taking. Thus, for example, the long term commitment of one's labor, as in *McFall*, involves the taking of a risk as to the market price of labor.

225. Sen. Rep. No. 1622, 83d Cong., 2d Sess. (1954) p. 445, states: "Further, application of the section determines only whether an exchange of the proceeds for the lease or agreement has taken place, but not whether such proceeds are gain from the sale or exchange of a capital asset or note; the latter is to be determined by other applicable provisions of law rather than by this section."

not for past services but for release from a promise to pay for future services due to a change in the market value of the employer's commitment, in *Bellamy* the receipt represented part of taxpayer's past earnings in the nature of a liquidation of a claim for services already performed, analogous to an account or note receivable for personal services.[226] Thus viewed, Bellamy's right, although "property" within the meaning of section 1221 if acquired by way of purchase, is not such "property" when received as compensation for past services.[227] This interpretation of *Bellamy* is reinforced by the Tax Court's rejection of *Commissioner v. Ferrer*[228] as controlling authority. There, taxpayer was held entitled to capital gains on the sale of a power to prevent disposition of certain motion picture rights which power was acquired incident to a "lease" of the right to produce a play. Distinguishing *Ferrer*, the Tax Court correctly noted that in that case the right was not acquired in consideration of the performance of personal services.

On the other hand the long-term employment contract seems to fall outside the Congressional purpose to reduce the deterrent effect of the ordinary income tax on the sales of capital investments, the so-called "lock-in," and thus encourage their sale.[229] This theory at least partially justifies the lower rate of tax as necessary to prevent the hindrance of sales of appreciated property and consequent re-investment. Arguably, in the case of personal service contracts there is no real "lock-in" because, unlike a share of stock or a piece of rental real estate where tax on the appreciation can be avoided merely by holding the property until death, the value appreciation in a personal service contract may not be deferred indefinitely since the appreciation must be realized over the period of

226. Herman Shumlin, 16 T.C. 407 (1951), where the producer of a successful play was entitled to share in the proceeds of any sale of motion picture rights as part of compensation for his services. A lump sum payment in release of these rights was held to be ordinary income, the Tax Court comparing the release with a discount of a note received in consideration of personal services. See also Helvering v. Smith, 90 F.2d 590, 592 (2d Cir. 1937).

227. Of course, if it had been possible to tax Bellamy on the value of his right at the time it was acquired, he would then have acquired it by "purchase" and any increase in its value would have given him capital gain. Silverstein, *supra* note 21, at 1289. *Cf.* Gilbert v. Commissioner, 56 F.2d 361 (1st Cir. 1932), decided when the predecessor of section 1221(1) excluded from the capital asset category "property held by the taxpayer primarily for sale in the course of his trade or business." The section now reads "property held . . . primarily for sale to customers in the ordinary course of his trade or business." See also Rev. Rul. 58-402, 1958-2 Cum. Bull. 15 regarding the valuation of contracts and claims to receive indefinite amounts.

Rights comparable to those held by Bellamy have been held to be capital assets where not acquired for personal services. Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962) (limited right to prevent disposition of motion picture rights to a play); Commissioner v. Ray, 210 F.2d 390 (5th Cir. 1954), *cert. denied*, 348 U.S. 829 (1954) (right of a lessee not to have the lessor enter into leases with competitors of the lessee); Commissioner v. Starr Bros. Inc., 204 F.2d 673 (2d Cir. 1953) (exclusive right to sell a manufacturer's products in a limited area); Hollywood Baseball Ass'n, 42 T.C. 234 (1964) (exclusive rights under the rules of monopoly baseball to prevent major league teams from playing baseball in their locations). In all of these cases, the taxpayer had a right which prevented competition with some interest or property of his, thus protecting his ability to earn income from that property. Bellamy had just such a right.

228. 304 F.2d 125 (2d Cir. 1962).

229. See generally Miller, *supra* note 25, at 1074-78; A.L.I. Draft, *supra* note 224, at 8-12.

the remaining life of the contract through the payments of salary. However, this is true of all assets which will yield income for a limited period such as a life estate, a lease, or fixed term obligations. The holder of such assets does not have the power to defer indefinitely the tax on an appreciation in value as does the holder of an asset which has an unlimited life.[230] Thus, if the owner of a stated interest bond does not take his appreciation by way of a sale, he will eventually be taxed at ordinary income rates as he receives the periodic interest payments over the life of the bond. The bond, therefore, presents no more of a "lock-in" problem than does the personal service contract and there is no reason for distinguishing between the two on this ground.

In summary, where a contract is solely for the rendering of personal services, the courts will deny capital asset status on the ground that the contract is not "property" capable of ownership, or that Congress never intended capital treatment for such contracts, or on the future income rationale. The intent of Congress regarding such contracts is somewhat ambiguous, but it is not so clear as not to warrant discussion and analysis and to be merely assumed as contrary to the taxpayer. The "property" and "future income" doctrines do not bear analysis and indeed are used as a substitute for analysis. The area is in critical need of re-evaluation by the courts in the light of notions of commitment to risk and value appreciation. However, hostility to such contracts seems so basic, there seems little hope for reconsideration at the judicial level. Recall the length to which the Court of Claims went to deny capital gain on the sale of a purchased right to a contingent legal fee in *Wilkinson v. United States*[231] where the taxpayer's personal services were involved. There, the Court seemed to hold as an alternative ground that the amount received on sale of the fee was compensation for taxpayer's personal legal services rendered in the case. However, although taxpayer acquired part of his rights to the fee in return for acting as attorney in the case, the portion of the fee that he sold was acquired by purchase and not for his services. Had he not made the purchase he would have had no right to that portion of the fee.[232] But because of the presence in the situation of his personal services, the Court denied capital gain treatment on what seems clearly to be an investment return.

However, labels are important in this area. If one can avoid selling the right to past or future income from "personal services" and sell instead "good will," the courts have little difficulty in finding capital gain.[233] In *George J. Aitkin*,[234] for example, taxpayer, employed as a solicitor by a casualty insurance agency, sold to the agency "insurance expirations" for 10,000 dollars. The expirations con-

230. See A.L.I. Draft, *supra* note 224 at 8.
231. See text accompanying notes 129-36, *supra*.
232. This was the position taken in the dissenting opinion of Justice Whittaker, 157 Ct. Cl. at 868, 304 F.2d at 480 (1962).
233. Commissioner v. Killian, 314 F.2d 852 (5th Cir. 1963); Nelson Weaver Realty Co. v. Commissioner, 307 F.2d 897 (5th Cir. 1962); Calley v. United States, 220 F. Supp. 111 (S.D. W. Va., 1963); Edward A. Kenney, 37 T.C. 1161 (1962); George J. Aitkin, 35 T.C. 227 (1960).
234. 35 T.C. 227 (1960).

sisted of taxpayer's files regarding policies issued which contained such information as expiration dates and premiums. The "expirations" were held to be capital assets in the nature of good will since they had a potential to produce future business as customer lists. This rule is, of course, recognized by both the Commissioner and the courts.[235] However, upon analysis, it is a difficult one to understand. In *Aitkin*, the value of the customer lists which comprised the good will sold was entirely attributable to the former personal services of the taxpayer. Thus, the value of the good will was no more than the value of taxpayer's past personal services which was reflected in the customer lists. Any amount ultimately received for that value arguably could be treated as earnings from personal services. It seems difficult to distinguish between such good will and amounts received for a covenant not to compete which are taxed as ordinary income.[236] Both represent the value of income that would otherwise be received in the future by the seller and which is already "earned" by past services.[237] Nevertheless, the courts give capital gain for the sale of goodwill, while denying it for sales of a right to perform services.

B. *Exclusive Agency, Distributorship and Other Contract Rights*

As distinguished from the contract only to perform personal services, the exclusive agency and other contracts discussed under this heading, while they involve personal services, also have associated with them other elements such as goodwill, physical property, and capital investment. Also, there is generally lacking a strict employee-employer relationship and the taxpayer can be viewed as owning a "business." Although the courts have had more difficulty in finding a place for these contracts in the capital asset definitional structure, with only a few exceptions capital asset treatment has been largely denied under one or more of three standard approaches.[238]

Under one theory, where there has been a cancellation or termination of the contract between the parties thereto, as distinguished from a transfer to a third person, the courts hold there is no "sale or exchange." The Commissioner has also succeeded on a second theory that the contract rights involved are not "property" and therefore are not capital assets. Thirdly, especially since *Lake*, the courts are prone to find that the payments received are essentially a substitute for future ordinary income.

1. *The Sale or Exchange Cases*

In *Commissioner v. Starr Bros., Inc.*[239] taxpayer received a lump sum settlement on the cancellation of a contract with a drug manufacturer under which

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235. See cases cited note 233 *supra*; Rev. Rul. 57-480, 1957-2 Cum. Bull. 47; Mertens, Law of Federal Income Taxation, § 22.50 (1955).
236. See generally Mertens, Law of Federal Income Taxation, § 22.33 (1955).
237. See Pines, *Federal Income Taxation of Intangible Assets*, 8 Tax. L. Rev. 231-37 (1953).
238. See generally Lyon & Eustice, *supra* note 50, at 346-353.
239. 204 F.2d 673 (2d Cir. 1953).

taxpayer had the exclusive agency to sell the manufacturer's products in a limited area. The receipt was held to be ordinary income. Assuming arguendo that the contract was a capital asset, the court held there was no sale or exchange since the taxpayer had merely released the manufacturer from its contractual obligation not to sell to other dealers in the area involved. This merely ended the manufacturer's duties toward the taxpayer and destroyed the taxpayer's rights; they were not transferred to the company. The transaction was analogized to amounts received on a note when it is surrendered for payment.[240] In another case involving an exclusive agency contract, *General Artists Corp. v. Commissioner*,[241] taxpayer was the exclusive booking agent for singer Frank Sinatra under a contract whereby it was to receive ten percent of his earnings from bookings. Taxpayer "sold" the contract to another agency, MCA Artists, Ltd., under an agreement that after the assignment the contract would be cancelled so that MCA would enter into a new contract with Sinatra. The amount received upon the "sale" was held to be ordinary income on the authority of *Starr Bros., Inc.* even though the transaction was cast in the form of a sale rather than a termination or cancellation. The Court viewed the transaction as in effect a cancellation by taxpayer of its contract with Sinatra in order to allow MCA to enter into original dealings with him. A similar result obtained in *Paul Small Artists, Ltd., Inc.*[242] where taxpayer, a booking agency, sold a contract with an actor to another agency for 25,000 dollars. Although there was no cancellation of the contract between the artist and the new agency, *General Artists* was held controlling and the receipt was ordinary income. Viewing the transaction simply as a termination of the relationship previously existing between the taxpayer and the artist and the creation of a similar but new relationship between the buying agent and the artist, the Tax Court found that in substance there was merely a substitution of one agent for another. "We do not think," said the Court, "that the form of the transaction, i.e., whether the old contracts were to be cancelled and new ones entered into, or whether the new agent simply stepped into the shoes of the old with the artist's consent, should lead to a result here different from that reached in *General Artists*."[243] A vigorous dissent pointed out that, unlike *General Artists*, the contract rights did not vanish, but were transferred and continued to survive in the hands of the buying agency.

Similar results have been reached in cases involving contracts giving the exclusive right to purchase all of another's production output. In *Commissioner v. The Pittston Co.*[244] ordinary income was held to flow from the cancellation of a contract under which the taxpayer had the exclusive right for a period of years to purchase all the coal mined by the operator of mining property. There was a termination and extinguishment of taxpayer's rights and therefore no sale

240. *Id.* at 674.
241. 205 F.2d 360 (2d Cir. 1953), *cert. denied*, 346 U.S. 866 (1953).
242. 37 T.C. 223 (1961).
243. *Id.* at 227.
244. 252 F.2d 344 (2d Cir. 1958).

or exchange. Specifically rejected was the Tax Court's position that the extinguishment of a contract duty to deal only with one person transfers to the transferee a right to deal with all the world. Also distinguished were the sale of life estate and cancellation of leases cases as relating to matters of "greater substance" than mere "contract rights."[245] The result was the same in *Marc D. Leh*[246] where taxpayer had entered into a long-term contract giving him the right to purchase from a corporation two and one-quarter million gallons of gasoline a month. Two years later, when gasoline was in short supply, taxpayer agreed to cancel and terminate the contract in consideration of 183 million dollars. Agreeing with the taxpayer that the contract was property used in the trade or business which, on sale, would give capital gain[247] the Court held there was no sale or exchange of the contract since all the taxpayer gave was a release from the obligation to sell gasoline. The only rights the taxpayer had were rights to buy gasoline and these rights were not "transferred"; they merely came to an end and vanished. Again the cancellation of lease cases were distinguished on the ground that a lease is a more substantial property right which does not lose its existence when transferred.[248]

However, a "sale" was found in *Commissioner v. Goff*[249] where taxpayers had provided machines to a manufacturing company under an agreement whereby the manufacturing company promised to pay for their use and to sell the produce of the machines to taxpayers alone. On a "sale" by taxpayers of their rights under the agreement to the manufacturing company, it was held that taxpayers were entitled to capital gain. "We do not see," stated the Court, "in principle how the person to whom a tangible right is transferred can affect the question whether the transfer is a sale or exchange."[250] The Court then went on to narrow its holding by relying upon the cancellation of lease doctrine, and distinguishing *Starr Bros.* and *General Artists,* to the effect that the lease cases involved more substantial rights and that the case at bar was within the cancellation of lease cases. The right that the taxpayer had to the exclusive product of machines "was a substantial right and, if it is important, it was a right connected with the use of specific tangible property, that is, the machines themselves."[251]

Although *Goff* shows dissatisfaction with the "sale or exchange" issue as a determining factor on the capital gains question, to a large extent it accords with the approach of most cases in making the determining factor for capital gains taxation whether the asset disposed of survives the transaction. This approach, however, seems to be merely a blind which is being used in an attempt to avoid the problem of deciding the basic issue of "property." The real inquiry

245. *Id.* at 347.
246. 27 T.C. 892 (1957), *aff'd,* Leh v. Commissioner, 260 F.2d 489 (9th Cir. 1958).
247. Int. Rev. Code of 1954, § 1231.
248. 27 T.C. at 898, 260 F.2d at 493.
249. 212 F.2d 875 (3d Cir. 1954), *cert. denied,* 348 U.S. 829.
250. *Id.* at 876.
251. *Id.* at 876-77.

is nevertheless directed toward the nature of the asset—whether it is one that survives or does not survive the transaction—and the courts are really deciding the "property" issue under the "sale or exchange" rubric. Because the technical requirements of a "sale or exchange" are more easily applied than the vague and difficult standard of "property," the courts understandably tend to decide the cases on that issue. In fact, in *Paul Small Artists, Ltd., Inc.*[252] the Tax Court went to the extent of using this test to deny capital gains treatment where there was an actual sale or exchange, pursuing an analysis that the "net effect" of the transaction was the same as the cancellation of the old agency agreement and the substitution of an identical new one with the transferee of the contract.

However, as noted, the courts have to constantly distinguish the cases allowing as a "sale or exchange" the cancellation of a lease favorable to the lessee on the ground, following the *Blair* approach, that a lease is more "substantial property." In *Commissioner v. Ferrer*,[253] taking a new tack, the Second Circuit relied on these cases to reject the distinction between a sale to a third person whereby the asset transferred continues to exist, and a release that results in its extinguishment. The facts in *Ferrer* are somewhat complicated. Briefly stated, in 1951 actor Jose Ferrer contracted with Pierre LaMure for Ferrer to produce a stage play based upon LaMure's novel "Moulin Rouge," a biography of Henri de Toulouse-Lautrec. Under the contract Ferrer acquired a "lease" of the right to produce the play, a power to prevent any disposition of the motion picture rights until the play had run for a period of time, and the right to receive forty percent of the motion picture proceeds if the play was in fact produced. In 1952, Ferrer agreed to cancel the contract with LaMure and to give up his rights in the play and movie receipts in consideration of a contract with John Huston's production company, whereby Ferrer would play the part of Toulouse-Lautrec in a movie and be paid a salary and a percentage of the net motion picture profits. In determining whether the amount received under the percentage arrangement was capital gain, the Court held there was a sale or exchange, rejecting the distinction between a sale to a third person whereby the asset transferred continues to exist, and a release that results in its extinguishment. The Court took Internal Revenue Code Section 1241 as "indicating Congressional disenchantment with this formalistic distinction."[254] Tax law, noted the Court, is concerned with substance and not form. It made no difference to the parties whether Ferrer sold his rights to Huston's company, Moulin, which would then release them to LaMure, or released them directly to LaMure for a consideration paid by Moulin. Both are "sales" and the nature of Ferrer's gain was determined by attacking the problem of whether he had sold a "capital asset."

Also rejecting a technical approach to "sale or exchange" is *United States v. Dresser Industries, Inc.*[255] where taxpayer released an exclusive license to

252. 37 T.C. 223 (1961).
253. 304 F.2d 125 (2d Cir. 1962).
254. *Id.* at 131.
255. 324 F.2d 56 (5th Cir. 1963).

practice a patented process in return for a percentage of the fees earned thereby. Criticizing the Commissioner's argument that there had been no sale but merely a "termination or relinquishment," and relying strongly on *Commissioner v. Ray*,[256] the Court found no difference between a transaction with a third party and one with the owner of the patent. As long as the transferor disposes of and the transferee obtains a valuable right, it does not matter that the right which is relinquished vanishes. "It is plain," said the Court, "that before the transaction, taxpayer had a right in property; after the transaction was consummated, it no longer had this right, but a claim to money."[257] Therefore, there was a sale or exchange.[258]

The approach of the Courts in *Ferrer* and *Dresser Industries, Inc.* not only makes good sense, but as noted in *Ferrer*, is in accord with the intent of Congress that the sale or exchange requirement not be applied in a technical formalistic manner. *Ferrer* noted Congressional "disenchantment" with the technicalities of the "sale or exchange" requirement, pointing to the enactment of section 1241 which presumes a "sale or exchange" upon certain cancellations of leases and distributors agreements. And, of course, there has been further long-standing evidence of such disenchantment.[259] Happily, the influence of *Hort* and *Blair* on the "sale or exchange" issue appears to be waning.

2. *The Future Income Rationale*

Prior to the decision in *Lake*, it had been held that a sale or cancellation of an exclusive agency contract was the sale of a capital asset.[260] In *Elliot B. Smoak*[261] taxpayer had an exclusive agency for leasing and licensing machines used in distributing milk and other dairy products and paper containers, under a royalty arrangement. A sale of his rights under the agency contract was held to be a sale of a capital asset—"a going agency business."[262] The case was held not to fall within *McFall* since taxpayer had sold more than the right to earn money by performance of services; he had also sold his office files, records, and the good will of the business which he had built up over the course of two years. Since good will is a capital asset the portion of the purchase price allocable thereto would clearly have been capital gain. However, the value of the right to earn future royalties under the agency contract was not so clearly a capital asset. By dealing with the transaction as if there had been a sale of a "business" the

256. 210 F.2d 390 (5th Cir. 1954), discussed in text accompanying notes 95-96, *supra*.
257. 324 F.2d at 59.
258. *Accord*: Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963).
259. Congress has attempted to make certain that capital gain or loss will or will not be the tax result in certain situations. See, *e.g.*, Int. Rev. Code of 1954 § 331(a) (corporate liquidations); § 302 (redemption of stock); § 1232 (satisfaction of certain corporate obligations); § 741 (transfer of a partnership interest); § 166(d) (nonbusiness bad debts); § 165(g) (worthless securities); § 1231 (certain involuntary conversions).
260. Jones v. Corbyn, 186 F.2d 450 (10th Cir. 1950); Elliot B. Smoak, 43 B.T.A. 907 (1941); Rev. Rul. 55-374, 1955-1 Cum. Bull. 370.
261. 43 B.T.A. 907 (1941).
262. *Id.* at 910.

Court sidestepped the problem involved in comminuting the business into its fragments and dealing with each of them separately.[263] A similar approach was taken in *Jones v. Corbyn*[264] where taxpayer had for ten years been the exclusive agent of a life insurance company under a contract giving him the right exclusively to solicit life insurance policies in Oklahoma. The contract was cancelled by the parties for a lump sum, taxpayer also transferring all of his books, records and files. No transfer was made of commissions earned or of renewal commissions. Rejecting the argument of the Commissioner that taxpayer had sold nothing more than an employment contract to perform personal services the amount received upon cancellation was held to be capital gain. The contract was said to have substantial value and to be capable of producing income. Furthermore, said the Court, the business built up through the efforts of taxpayers over the years, netting approximately 30,000 dollars per year to the agency was a valuable asset which had been transferred. The Court thus pointed to two separate elements which had been sold: the agency contract, which in itself had value, and the value of the "business." The second element perhaps represented the value of the good will inherent in the customer leads which would be provided by the office files and records. However, the Court failed to deal separately with the assets sold and therefore the appreciated value of the contract right to represent the insurance company as an exclusive agent was given capital gain treatment. This caused a dissent on the ground that the only transfer was of the right to act as agents of the insurance company which was merely a right to render future personal services and to earn compensation therefor. Such commissions, argued the dissent, would have been ordinary income when earned and so a lump sum paid for the surrender of the right to render such services must also constitute ordinary income. The dissent, of course, is right on the point that part of what taxpayer transferred was the right to perform personal services. Had the Court comminuted the business into its fragments under the rule of *Williams v. McGowan*[265] it would have been required to deal with the position taken in *McFall* that the sale of the right to render future personal services is not a capital asset. However, this issue is apparently clouded by the bundle of rights which is sold as a "business." Even the Commissioner has held that a sale of an exclusive distributorship with a foreign manufacturer, where no physical assets or fixtures are conveyed, is a capital asset because such a contract is not excluded from the capital asset definition of section 1221.[266]

Since the Supreme Court has decided *Lake*, the courts have separated the elements involved in the sale of a business and come to grips with the issue of the sale of a right to earn future personal services income. Ignoring *Jones v. Corbyn* the Fifth Circuit in *United States v. Eidson, Jr.*[267] held that ordinary

263. See Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945).
264. 186 F.2d 450 (10th Cir. 1950).
265. 152 F.2d 570 (2d Cir. 1945).
266. Rev. Rul. 55-374, 1955-1 Cum. Bull. 370.
267. 310 F.2d 111 (5th Cir. 1962); *accord*, Hyatt v. Commissioner, 325 F.2d 715 (5th Cir. 1963).

income was realized upon a sale of a general agency contract with a mutual insurance company having six years to run. Square reliance was placed upon *Lake*. No capital asset was sold since the amount received on the sale represented the present cash value of what otherwise would have been compensation for personal services over the balance of the life of the contract.[268] A prior decision of the same Court[269] was distinguished on the ground that it involved a sale of good will. The holding in *Eidson* accords with the position of the Ninth Circuit in *Holt v. Commissioner*[270] in treating the payment received on the sale of the contract as if it were received as compensation for services performed. Although taxpayers argued that they were not required to perform services after the sale, thus pointing up the fact that the receipt was not for services performed or to be performed, this fact was held not to affect the nature of the payment, but only its amount.[271] The Court refused to recognize the appreciation in value of the commitment to pay a stated compensation for personal services and that the receipt reflected that appreciation. The Fifth Circuit reaffirmed the position taken in *Eidson* in *United States v. Woolsey*[272] which involved a sale of interests in a partnership which owned a nineteen year exclusive management contract with a mutual insurance company. On the authority of *Lake*, the proceeds from the sale allocable to the contract were held to result in ordinary income. The extent to which the future ordinary income rationale can be carried is illustrated by the statement of the Court that:

> It is always pertinent to inquire how the proceeds to be received would have been taxable if there had been no assignment of the contract. Close scrutiny is required if the consideration received is actually a present substitute for what would have been ordinary earned income in the hands of the assigning taxpayer, if the assignment or transfer had not been made.[273]

Looking at the underlying right assigned, the Court concluded that the amount received on the sale which was allocable to the value of the contract was ordinary income since it related to the right to earn ordinary income in the future for personal services.[274] Besides its general reliance on *Lake*, the Court found that section 751,[275] which treats as ordinary income amounts received on sale of a partnership interest attributable to "unrealized receivables," precluded capital gain treatment. Section 751 defines an "unrealized receivable" as a right to

268. 310 F.2d at 117.
269. Nelson Weaver Realty Co. v. Commissioner, 307 F.2d 897 (5th Cir. 1962), discussed in text accompanying notes 285-290, *infra*.
270. 303 F.2d 687 (9th Cir. 1962).
271. "That is," stated the Court, "the fact that the taxpayers would have to spend their time and energies in performing services for which the compensation would be received merely affects the price at which they would be willing to assign or transfer the contract." 310 F.2d at 115.
272. 326 F.2d 287 (5th Cir. 1963).
273. *Id.* at 291.
274. *Ibid.*
275. Int. Rev. Code of 1954, § 751.

payment for "services rendered, or to be rendered."[276] Holding that the amount received for the contract was for "services . . . to be rendered," the Court treated the sale proceeds as if for actual performance by the taxpayers of the contract, ignoring the fact that no future services were to be rendered. The payment was not for any services but for appreciation in the value of the contract. However, capital gain was given to amounts received for the sale of the taxpayers statewide charter, operating records and good will, the Court requiring that the consideration be comminuted into its fragments and allocated among the various assets sold.[277] In *Bisbee-Baldwin Corp. v. Tomlinson*,[278] the Fifth Circuit again held against a taxpayer who had terminated an agency relationship by selling certain mortgage servicing contracts under which taxpayer earned a fee for personal services in servicing the loans. The termination fee was ordinary income under *Hort* and *Lake* principles to the extent that it represented the right to earn future ordinary income. A conflict with a prior decision in the same circuit[279] was noted, and the distinction there made, that what was received bore no relation to the amount of future income that could be earned, was rejected on the basis of *Eidson*, and the rationale of *Lake* was held controlling. As to the portion of the purchase price allocable to taxpayer's files and records, which possessed independent value as customers lists, the Court held there had been received capital gain. *Bisbee-Baldwin Corp.* was followed by the Fifth Circuit in *General Guaranty Mortgage Co. v. Tomlinson*[280] where a mortgage servicing contract with taxpayer was terminated because the bank whose mortgages were being serviced determined it could do the servicing for one-half the amount being paid the taxpayer. That amount was held to have been received as a substitute for future servicing commissions and again allocation was required between ordinary income amounts and those allocable to the purchase of good will items.

In a case involving an exclusive license to use and to sub-license the use of a patented process where, being unable to keep up with the demand for the process, taxpayer relinquished its exclusive license in return for a non-exclusive license and a percentage of royalty payments to be received by the licensor from other licensees, the Tenth Circuit in *Wiseman v. Halliburton Oil Well Cementing Co.*[281] held the proceeds of the sale of the license were ordinary income, rejecting its decision in *Jones v. Corbyn* and relying on the traditional *Hort-Lake* future income rationale. The Court also stressed the absence of capital investment.[282]

In the wake of the above decisions by the courts of appeals, the Tax Court

276. Int. Rev. Code of 1954, § 751(c)(2).
277. 326 F.2d at 292.
278. 320 F.2d 929 (5th Cir. 1963).
279. Nelson Weaver Realty Co. v. Commissioner, 307 F.2d 897 (5th Cir. 1962), discussed in text accompanying notes 285-90, *infra*.
280. 335 F.2d 518 (5th Cir. 1964).
281. 301 F.2d 654 (10th Cir. 1962).
282. *Id.* at 658.

has adopted the *Hort-Lake* rationale in the agency contract area. In *Joseph W. Brown*[283] the sale of a contract under which taxpayer worked as director of agencies for an insurance company was held to give rise to ordinary income under *Lake, Eidson* and *Bisbee-Baldwin Corp.* In *Pridemark, Inc.*,[284] involving a service organization which solicited customers for a construction company in return for a commission on the price of houses built and work done, ordinary income was held to have been received on the sale of a number of contracts with customers on which no deliveries of materials had been made or work done, relying on *Lake* and *Eidson.*

In rejecting *Jones v. Corbyn,* the above decisions apply literally the *Hort-Lake* doctrine and treat the taxpayer's receipts not allocable to goodwill as payment for actual performance of the contract. Other decisions in the Fifth and Second Circuits, however, recognize the fallacy inherent in that doctrine and allow capital gain for receipts which seem to represent the value of the right to perform future services. *Nelson Weaver Realty Corp. v. Commissioner*[285] involved the assignment of a mortgage servicing contract similar to that in *Bisbee-Baldwin Corp.* In the course of servicing mortgages for a life insurance company under the contract, the taxpayer had accumulated 1830 mortgage accounts, and sold its right to service these accounts, all the records and files compiled over the years in connection with these mortgage loans, and also a list of approximately 1600 mortgagors who were satisfied former customers of taxpayer. The Court noted that these records provided a ready made market for future loans and as prospects for sales of homes, insurance and like items. "It cannot be doubted," said the Court, "that the sum total of the ingredients of this long-standing relationship with such a satisfied clientele constitutes a property right which is the equivalent of good will—the probability that the old customers will resort to the old place."[286] Therefore the entire amount received, about 120,000 dollars, was capital gain. However, the entire 120,000 dollars was not received for the value of good will. In rejecting the application of *Lake,* where the sales price of the oil payment was almost the exact equivalent of the income to be produced in the future, the Court noted that the amount paid for the right to service the assigned mortgage accounts was the buyer's anticipated net profit after his costs of collection, only about 16,000 dollars.[287] This amount represented the excess of the value of the right to perform the personal services required in servicing the accounts over the cost of performance. It is the amount by which the commitment to pay for such services had appreciated above the cost of performance as evidenced by the fact that the buyer was willing to pay this amount in order to substitute his own performance at a smaller net return. The seller, therefore, received gain for the sale of the appreciated commitment in the con-

283. 40 T.C. 861 (1963).
284. 42 T.C. 510 (1964).
285. 307 F.2d 897 (5th Cir. 1962).
286. *Id.* at 901.
287. *Id.* at 902.

tract with the life insurance company and the holding in *Nelson Weaver* is that this gain is capital gain and not compensation for performance of services.

Rejected was the *Hort-Lake* principle, the position of the dissent that the amount paid for the right to receive service fees for the remaining years of the outstanding loans was "simply converting future income into present income"[288] and that the portion of the sales price allocable to the "future income" was ordinary income. Also, the argument of the Commissioner that the controlling principle was that of *Corn Products Refining Co.*[289] was rejected. The Court held that the isolated sale of an agency contract cannot be equated to the routine day-to-day sale of corn futures as part of everyday business operations. *Corn Products* was thus narrowly construed as applying only to business property which is in the nature of stock in trade or property held for sale to customers.[290]

A more explicit criticism of the *Hort-Lake* future income doctrine was made in *United States v. Dresser Industries, Inc.*[291] where the Fifth Circuit was presented with a situation similar to that in *Halliburton Oil.* Taxpayer owned an exclusive license to practice a patented process in return for a percentage of the fees earned thereby. Fifteen years after acquiring the license, the taxpayer agreed with the patentee to release his exclusive rights, retaining a non-exclusive right to practice the patent, in return for 500,000 dollars payable by the patentee out of his future earnings from the license. Rejecting the application of *Corn Products* by giving it a restrictive "stock in trade" interpretation, and holding that *Lake* did not apply since taxpayer sold the entire "exclusivity" feature, a "vertical slice" rather than a "carve out," the Court held that taxpayer had sold income producing "property." *Halliburton Oil* was distinguished on the ground that there the taxpayer had a right to sub-license the patent and the receipt was attributable to this right so that taxpayer "merely substituted the right to receive ordinary income from one source for the right to receive ordinary income from another."[292] However, this attempt at distinction loses its force in view of the Court's lengthy analysis and criticism of the *Hort-Lake* future income rationale. The Court felt compelled to answer the government's "broad assertion . . . that, in any case where the purchase price includes anticipated income there can be no capital gains treatment. . . ."[293] Criticizing the *Eidson* Court's literal acceptance of the Supreme Court's generalization in *Lake* to mean that any amount paid which represents the present value of future income to be earned is taxed as ordinary income, the Court noted that:

> As a legal or economic position, this cannot be so. The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value

288. *Ibid.*
289. 350 U.S. 46 (1955).
290. For an excellent discussion of the role of *Corn Products* in this area see Chirelstein, *supra* note 47, at 36-43.
291. 324 F.2d 56 (5th Cir. 1963).
292. *Id.* at 59. On this point see Chirelstein, *supra* note 47, at 28, 29.
293. 324 F.2d at 58.

of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income . . . the fact that the income which *could* be earned would be ordinary income is immaterial; such would be true of the sale of all income-producing property.[294]

In the course of its discussion, the Court emphasized that there is "a vast difference between the present sale of the future right to *earn* income and the present sale of the future right to *earned* income."[295] This statement, of course, clearly differentiates the sale of the right to future earnings from the sale of the right to past earnings, the latter clearly giving rise to ordinary income under the "accrued income" cases. The sale of the right to earn future income, however, is not the same as earning it under the rationale of this case. The value of the right to practice the patent had obviously increased over the period of years it was practiced by the taxpayer, and capital gain treatment was accorded for this increase in value.

The *Hort-Lake* approach was also rejected by the Second Circuit in *Commissioner v. Ferrer*.[296] Holding that amounts received for surrender of a lease of a play were capital gains, the Court noted that the future income rationale was inconsistent with the capital gain treatment accorded to a lessee of real property upon the sale of a lease from which he is receiving business income or subrentals under *Golonsky, McCue Bros.* and *Drummond*, and section 1241. Likewise, held the Court, capital gain was not prevented because the sales price

294. *Id.* at 59. Judge Brown, concurring, further criticized the Commissioner's position:

I think this is both bad economics and faulty law. A person acquires property for one of two, or both reasons. The first is to receive earnings, i.e., income. The other is to hold the property for appreciation resulting from long or short range economic conditions, inflation or the like. Normally, of course, the predominant reason is to acquire the earning capacity represented by the earnings which the property will generate.

Hence it is that among those who trade in corporate securities on established national exchanges or over-the-counter markets, there are recognized rules of thumb by which the present value, hence market price, is determined for a given stock. The same is true in the contemporary, frequent practice of large-scale corporate acquisitions by one corporation of the stock or assets of another corporation. Value —market or sales price—is determined by capitalizing earnings. Whether the formula is the conservative one of 6 or 7 times earnings, or something less, or one considerably more speculative, what the buyer offers is his estimate of the present, discounted value of the future earnings of the assets or enterprise.

But although this sales price is determined by future earnings, and to the seller it takes the place of what he would have received had he continued his ownership, under no stretch of the imagination is it "ordinary income" either in the business world or in the sometimes more weird, tax world. Were this so, then every such sale for a price in excess of cost would entail this analysis and this tax consequence. There would first have to be ascertained what portion of the excess represented the present value of future earnings and what portion represented merely capital appreciation, from enhancement in value caused by inflation, scarcity or the like. Then as a second step, that portion or the excess of sales price representing future earnings would be taxed as ordinary income, the remainder as capital gains.

Conceding that Congress might compel this, that the ubiguitous and voracious tax gatherer might demand it, or that courts might ultimately sustain it, the fact is that as yet none has gone so fast so far.

Id. at 61.

295. *Id.* at 59.

296. 304 F.2d 125 (2d Cir. 1962).

was to be paid in deferred payments over a number of years rather than in a lump sum, downgrading the importance of this factor in the capital gains policies. Also in *Dorman v. United States*,[297] where an option to acquire a partnership interest was held a capital asset, the Ninth Circuit rejected the Commissioner's argument that the proceeds of the sale of the option was ordinary income. Agreeing with him that the payment received on sale of the option was compensation for the loss of future profits, the Court came to the opposite conclusion and held the contractual rights representing such value was a capital asset.

In summary, it is difficult to see the development of any consistent rule regarding the application of the *Hort-Lake* future income rationale. The Ninth Circuit in *Holt*, the Fifth Circuit in *Eidson, Woolsey, Bisbee-Baldwin Corp., General Guaranty Mortgage Co.*, and the Tax Court in *Brown* and *Pridemark Inc.*, have applied *Hort-Lake* to deny capital gain to the amounts received upon sale of a contract requiring future personal services of the seller. The same rule has been applied by the Tenth Circuit in *Halliburton Oil*, a case involving the appreciation in value of an exclusive license to practice a patent. Rejecting the *Hort-Lake* principle in the area of contracts requiring the performance of personal services is the decision of the Fifth Circuit in *Nelson Weaver Realty Corp.*, which appears to be in clear conflict with *Holt* and with decisions of another panel of the same Court in *Eidson, Bisbee-Baldwin Corp., Woolsey* and *General Guaranty Mortgage Co.*, all involving management or mortgage-servicing contracts. And the decision of the Fifth Circuit in *Dresser Industries Inc.* seems to reach a result contrary to *Halliburton Oil* in the area of exclusive license or patent contracts. Perhaps the Fifth Circuit's lucid exposition in *Dresser Industries* of the future-income rationale will lead to greater consistency of decision in similar cases. However, it is difficult to predict the impact of *Dresser Industries* where the contract sold is one calling for future personal services and involves no physical property such as a patent, as, for example, the situations presented in *Holt* and *Eidson*. There seems to be no reason in theory why the future income rights in such cases should be less qualifying property than in *Dresser Industries*. There, the lack of commitment of funds or credit was ignored so apparently the Fifth Circuit, unlike the Tenth Circuit in *Halliburton Oil*, will not require a capital investment. Moreover the Court's decision in *Nelson Weaver Realty Inc.*, and its explicit criticism of *Eidson* in *Dresser Industries* provide evidence that the *Dresser Industries* rule will receive broad application by at least one panel of the Fifth Circuit.[298]

3. *"Naked Contract Rights"*

The third approach of the courts in denying capital gain on the sale or cancellation of contracts is to deny the contract status as "property." Thus, if

297. 296 F.2d 27 (9th Cir. 1961).
298. See, Chirelstein, *supra* note 47, at 25, n.77.

the taxpayer is held to have a "naked contract right"[299] as distinguished from right of more "substance"[300] than mere contract rights, he will not have a capital asset. The rule is also expressed in terms of taxpayer's remedy for breach of the contract. If his remedy is an equitable one for an injunction or specific performance, then his contract is "property." If he can obtain relief only in damages, he has no "property."[301]

The Second Circuit first applied these concepts in *Commissioner v. The Pittston Co.*[302] where taxpayer received 500,000 dollars on the cancellation of a contract under which he had the exclusive right to purchase the output of a mine. Denying capital gain treatment, the Court noted that the contract "carried with it no direct interest in the mine itself, or in the coal produced."[303] "It was a naked contract right," continued the Court, "not in the nature of a lease or a profit *à prendre*."[304] Distinguished were the lessee-cancellation cases[305] and the sale of life estate cases[306] as involving rights having more "substance than mere contract rights."[307] In support of this analysis, the Court noted that if the mine owner had been able to find someone other than the taxpayer who would sell his coal at less cost to him taxpayer's only remedy would have been in damages. The Court added that the receipt was essentially a substitute for future ordinary income, and that the cancellation suggested a "tax avoidance purpose."[308]

A vigorous dissent argued that taxpayer had sold more than "naked contract rights," and, also pointed out that the future income rationale was misapplied since any future income payable under the contract would first have to be earned by efficient operation on the taxpayer's business. The 500,000 dollars received was not "future income" but the value to the mine owner of having himself and his property free of the commitment to sell exclusively to the taxpayer; that is, it reflects not future income, but the value of the asset sold.[309]

Because the *Pittston* result is based on several grounds, including a lack of "sale or exchange," the case is not square authority that capital asset status turns upon the availability of equitable relief. Such authority is provided, however, by the decision of the Second Circuit in *Commissioner v. Ferrer*.[310] The facts in *Ferrer* bear repetition. In 1951, actor Jose Ferrer entered into a standard

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299. Commissioner v. Pittston Co., 252 F.2d 344 (2d Cir. 1958); accord, Rev. Rul. 56-531, 1956-2 Cum. Bull. 983.
300. Commissioner v. Pittston Co., *supra* note 299.
301. *Ibid.* Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962).
302. 252 F.2d 344 (2d Cir. 1958).
303. *Id.* at 348.
304. *Ibid.*
305. Commissioner v. McCue Bros. & Drummond, Inc., 210 F.2d 752 (2d Cir. 1954); Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952), *cert. denied*, 345 U.S. 939 (1953).
306. McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946).
307. This proposition is highly reminiscent of the view taken in Thurlow E. McFall, 34 B.T.A. 108 (1936), that a long term employment contract is not the same as "a share of stock, a bond, or a thing." *Id.* at 110.
308. 252 F.2d at 348.
309. *Id.* at 350.
310. 304 F.2d 125 (2d Cir. 1962).

contract with Pierre LaMure whereby he agreed to produce a stage play based upon LaMure's novel "Moulin Rouge," a biography of Henri de Toulouse-Lautrec. By the contract, Ferrer was "leased" the exclusive right to produce and present the play in the United States and Canada. He also acquired the right to prevent any disposition of the motion picture rights prior to the time the play had run for a specified period of time, and the right to receive 40 percent of the motion picture proceeds if the play was in fact produced and presented according to the contract requirements. The contract specifically reserved to LaMure all title, both legal and equitable, to all rights, including the movie, radio and television rights, other than the right to produce the play. In 1952, after being approached to play the part of Toulouse-Lautrec in a movie to be made by Moulin Productions, Inc., John Huston's production company, Ferrer agreed to cancel the contract with LaMure, thus allowing Huston to obtain the motion picture rights, in consideration of a contract with Moulin whereby Ferrer would play the part of Toulouse-Lautrec in a motion picture in return for a stated salary together with a percentage of the net motion picture receipts. In 1953, after the motion picture, "Moulin Rouge," was completed, in addition to his salary which he reported as ordinary income, Ferrer received 180,000 dollars as his share of the percentage receipts. This amount he claimed to be capital gain arising out of his sale of the contract.

Clearing the way for an analysis of what rights Ferrer conveyed, the Court held against the Commissioner's contention that a "cancellation" is not a "sale or exchange,"[311] found that any interest held by Ferrer was not excluded from capital asset classification by section 1221(3) since Ferrer was in the role of an investor of capital taking a risk and was not the "creator" of the artistic work,[312] and rejected the application of the *Lake* future income rationale.[313] Also, the finding of the Tax Court that the percentage compensation was to no extent received for personal services but solely for the release of the contract was upheld. Noting that although performance of personal services as an actor was a necessary condition to the payment of the percentage compensation, nevertheless, held the Court, the right was given in consideration of the cancellation of the contract with LaMure.

The Court approached the problem of the nature of Ferrer's rights by noting that there was no single definitive test of a capital asset either in the statute or in the cases. Observing that it was "difficult, perhaps impossible, . . . to frame a positive definition of universal validity," it seemed to be criticizing *Pittston* when it stated:

> Attempts to do this in terms of the degree of clothing adorning the contract cannot explain all the cases, however helpful they may be in deciding some, perhaps even this one; it would be hard to think of a

311. See text accompanying notes 252-58, *supra*.
312. 304 F.2d at 132.
313. *Ibid.*

contract more "naked" than a debenture, yet no one doubts that is a "capital asset" if held by an investor.[314]

Having said that, the Court sought to find a solution by analysis of cases in "adjacent areas."[315] After rejecting *Jones v. Corbyn,* it launched into a synthesis of these cases and concluded:

> One common characteristic of the group held to come within the capital gain provision is that the taxpayer had either what might be called an "estate" in (Golonsky, McCue, Metropolitan), or an "encumbrance" on (Ray), or an option to acquire an interest in (Dorman), property which, if itself held, would be a capital asset. In all these cases the taxpayer had something more than an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another (Starr, Leh, General Artists, Pittston), or by rendering services (Holt), or by virtue of ownership of a larger "estate" (Hort, P. G. Lake). We are painfully aware of the deficiencies of any such attempt to define the wavering line even in this limited area, but it is the best we can do.[316]

The Court then went on to deal separately with each of the three rights sold by Ferrer; his "lease" of the exclusive right to produce the play, his power to prevent disposition of the motion picture rights, and his right to receive forty percent of the motion picture proceeds. Amounts received for surrender of the "lease" of the play were capital gains since an interest similar to that of a lessee's had been given up. Such an interest, held the Court, was an "equitable interest" in the copyright itself, interference with which would have been enjoined by a court of equity. Therefore, it constituted "property" under section 1221. The second right, Ferrer's power to prevent disposition of the motion picture proceeds until after production of the play, was also held to constitute an equitable interest in the copyright which would be protected by a court of equity. The Court stressed that the factor of injunctive relief distinguished this case from *Pittston.* Furthermore, held the Court, this right was a "cloud" on LaMure's title in the nature of a negative covenant on the motion picture rights and "the dissipation of the cloud arising from the negative covenant seems analogous to the tenant's relinquishment of a right to prevent his landlord from leasing to another tenant in the same business, held to be the sale or exchange of a capital asset in *Ray.*"[317] The third right, to receive forty percent of the proceeds of the motion picture, was held not to be a capital asset because of the specific provision in the contract that all legal and equitable rights in the motion picture rights, other than the right to receive the percentage receipts, were retained by LaMure. Ferrer therefore had obtained no property interest in the film rights enforceable in a court of equity and so any amount allocable to the release of this right was ordinary income.

314. 304 F.2d at 129-30.
315. *Id.* at 130.
316. *Id.* at 130-131.
317. *Id.* at 133.

The *Ferrer* rule was applied in *Maryland Coal & Coke Co. v. McGinnes*[318] where the District Court found ordinary income on the termination of an exclusive agency agreement entitling the taxpayer to sell all the coal from a mine for the entire life of the mine at a stated commission. Rejecting *Jones v. Corbyn* and citing *Ferrer*, the Court held that the agency contract was not a capital asset for the reason that it failed to confer upon the taxpayer "an enforceable estate, encumbrance or interest in an object or thing . . . the right created was simply one to perform a service, that of an agent to sell his principal's interest in . . . the coal which . . . carries with it no interest in either the coal or the mine."[319] Since taxpayer had only the right to perform services for compensation, continued the Court, its only means of redress for breach of contract was a suit for damages and it was only this right to damages that was sold. This is not a capital asset, held the Court, under the "overwhelming authority"[320] of such cases as *Eidson*, *Holt*, and *Pittston*. Distinguished were the lease cancellation cases as involving more than a mere contractual opportunity to earn periodic receipts by rendering services. In this group was included *Dresser Industries* because the taxpayer had an interest in a patent. Also distinguished were the cases such as *Bisbee-Baldwin Corp.*, *Nelson Weaver Realty Co.*, and *Elliot B. Smoak* which were held to involve the sale of goodwill items.

The "equitable interest" standard seems to be an elaboration upon and to derive directly from the "naked contract" principle of *Pittston*. It also has obvious overtones of "substantial property" deriving from *Blair* and conveyed through *Blair's* direct descendants, the life estate and lease cancellation cases. Indeed, the emphasis in *Blair* on the difference between "an equitable interest in property" and a mere "chose in action"[321] could be used as a restatement of the *Ferrer* principle. This principle requires that in order to have a capital asset, one must have more than simply a claim for money to be earned by the performance of services or by dealing with another; there must be some ownership interest in the property with which the contract deals. This rule comes about not through any considered relationship with capital gains policies, but rather through a synthesis of the decisions dealing with contractual rights, which decisions themselves were not reasoned from the proper policy premises. The result is a synthetic rule which, although it gives a great degree of certainty to the capital asset definition, fails seriously to carry out the intent of Congress.

The first objection to the rule is that it lets form control substance. Ferrer's third right—to share in forty percent of the proceeds of any motion picture if he produced the play—was held to be an ordinary income asset because it did not represent an interest in the underlying copyright but only in the proceeds therefrom. However, it made no practical or economic difference in the rights of the parties whether Ferrer received forty percent of the proceeds of the movie

318. 225 F. Supp. 854 (E.D. Pa. 1964).
319. *Id.* at 857-58.
320. *Id.* at 856.
321. See text accompanying notes 51-52, *supra*.

under the arrangement made or because he owned a forty percent interest in the portion of the copyright relating to the motion picture rights. Secondly, to allow the definition of a capital asset to turn basically upon notions of "equitable estates" and concepts of "remedy" is to introduce into the capital asset definition matters essentially unrelated to capital gains policies. The *Ferrer* opinion recognized that "it would be hard to think of a contract more 'naked' than a debenture, yet no one doubts that is a 'capital asset' if held by an investor."[322] In the light of this statement, the Court's lengthy development of an "equitable interest" standard is at least puzzling. If the sale of a bond gets capital gain upon the general decline of interest rates, then the sale of a right to render services or to deal with another should not be denied capital gain after a drop in the cost of the seller's performance on the ground essentially that the contract right is "naked." Moreover, aside from the obvious example of the debenture or bond, both the Commissioner and the courts have given capital gains status to "naked" rights to share in future profits.[323] These cases reflect the intent of Congress and the position of the Supreme Court that capital gain be allowed for gain due to the appreciation in value of an investment asset. Value appreciation can be present without regard to the ownership of an equitable interest in property or availability of a specific remedy.

Perhaps the "substantial property" standard is an attempt to articulate a requirement of capital investment in order to have an "investment." But even here it would prove too much since it would rule out of the capital asset category the lease, which it was not intended to do since the lessee-cancellation cases are the foundation of the Court's reasoning in *Ferrer*. Or, the test may be tied up with the necessity under the contract to perform personal services. The Court did approve the finding of the Tax Court in favor of *Ferrer* on this issue. Nevertheless, the Court's reliance on *Herman Shumlin*[324] a case involving a sale of accrued personal service income, and on *Holt*, seems to indicate that although the Court did not find Ferrer was being paid for past services, perhaps it felt that his right to share in the motion picture proceeds was compensation for services rendered or to be rendered.[325] Also, and even though the Court rejected the future income rationale, there may still be a tendency to treat amounts paid for the increase in value of a commitment to perform services as paid for the actual performance thereof. Thus, the Court in *Maryland Coal & Coke Co.* relied on *Eidson* and *Holt* and stressed the fact that the taxpayer's "only right was to perform services for compensation."[326] The problem with this statement may arise from the fact that the emphasis is in the wrong place; it could be rephrased as follows: "taxpayer's only right was to receive compensation for personal services." Thus expressed the emphasis is on the commitment of the

322. 304 F.2d at 129.
323. See note 132, *supra*; see also, Chirelstein, *supra* note 47, at 32-36.
324. 16 T.C. 407 (1951).
325. Chirelstein, *supra* note 47, at 23, 24.
326. 225 F. Supp. at 858.

mine owner to pay, and it can be more easily seen that the value of that commitment has increased.

The *Ferrer* case, while rejecting the largely irrelevant *Hort-Lake* rationale and placing the "sale or exchange" issue in its proper perspective, nevertheless launched a new test which stems from *Blair*, a test of "substantial property." This appears to be a substitution of one irrelevancy for another; a reliance upon a different branch of the "fruit-tree" metaphor in defining a capital asset.

V. Conclusion

Just prior to the writing of this section there was published in the Annual Report of the Section of Taxation of the American Bar Association[327] a subcommittee report on a study concerning the nature of gain from the disposition of personal service contracts. The subcommittee could make no present recommendation for legislation, and made an observation that nicely sums up the effect of "fruit and tree" on the capital asset definition:

> on the basis of an exhaustive analysis of the authorities, . . . it is extremely difficult to reconcile the treatment of certain contractual relationships as giving rise to ordinary income (*i.e.*, the "assignment of income" cases) with the common-law concept of property rights, which supposedly underlie the capital gain definitional sections. The subcommittee was able to conclude that many of the problems in this vexing area of analysis are settled judicially by virtue of the placement of given contract receipts in pigeon holes which have traditionally come to connote either capital gain or ordinary income. The subcommittee recognized that ultimate resolution of the problems in this area of taxation can only be achieved when the purposes of the capital gains privilege itself are more fully articulated by the Congress.[328]

It would indeed be profitable to have the purposes of the capital gains privilege better articulated by Congress. However, it is submitted that there has been sufficient articulation to avoid some of the complexity referred to in the subcommittee report. This complexity stems, in the main, from an attempt to simplify the problem of capital asset definition through use of "fruit and tree." The resulting "pigeon holes," however, have only the advantage of apparent simplicity. The "future income" rationale of *Hort-Lake* becomes increasingly difficult to handle as the courts extend its reach to traditional capital gains transactions. The "property" approach of *Blair*, attractive in lending a degree of certainty and scope to the capital asset definition, is essentially irrelevant to the Congressional purposes regarding preference for conversion of investment gains due to appreciation in value. The connection between "equitable remedy" and "substantial property" on one hand and investment property, such as a bond, on the other has yet to be demonstrated.

Nor is the difficulty of the problem of defining property lost upon the

327. 1 A.B.A. Bulletin Section of Taxation July 1965.
328. *Id.* at 107-08.

courts. Apparently this difficulty has led them to define the nature of a capital asset via the "sale or exchange" route. By using a test of whether the asset transferred survived the transaction, there was avoided the need to struggle with the more difficult problem of whether the asset was "property." Nevertheless, this process is merely another way of defining "property." Its use again lends certainty and scope to the capital asset definition. But the test is in no way related to Congressional purpose in this respect. Indeed, the subcommittee report above mentioned took the view that:

> the sale or exchange requirement is essentially a technical stumbling block, which ought not be dispositive of the issue of capital gain on this type of property rights. Thus, the subcommittee has under active consideration an amendment to § 1241 ("sale or exchange" treatment granted to cancellation of certain types of franchises and agreements) which would extend the provisions of that section to the cancellation or extinguishment of any contract right, and would treat the proceeds thereof as derived from a sale or exchange.[329]

Whether or not Congress again addresses itself to this complex problem, it is time for a re-evaluation upon the part of the courts as to the effect of the "assignment of income cases" upon the capital asset definition. The severance of "fruit and tree" from "property" as used in section 1221 can only help to untangle complexity.

329. *Id.* at 108.